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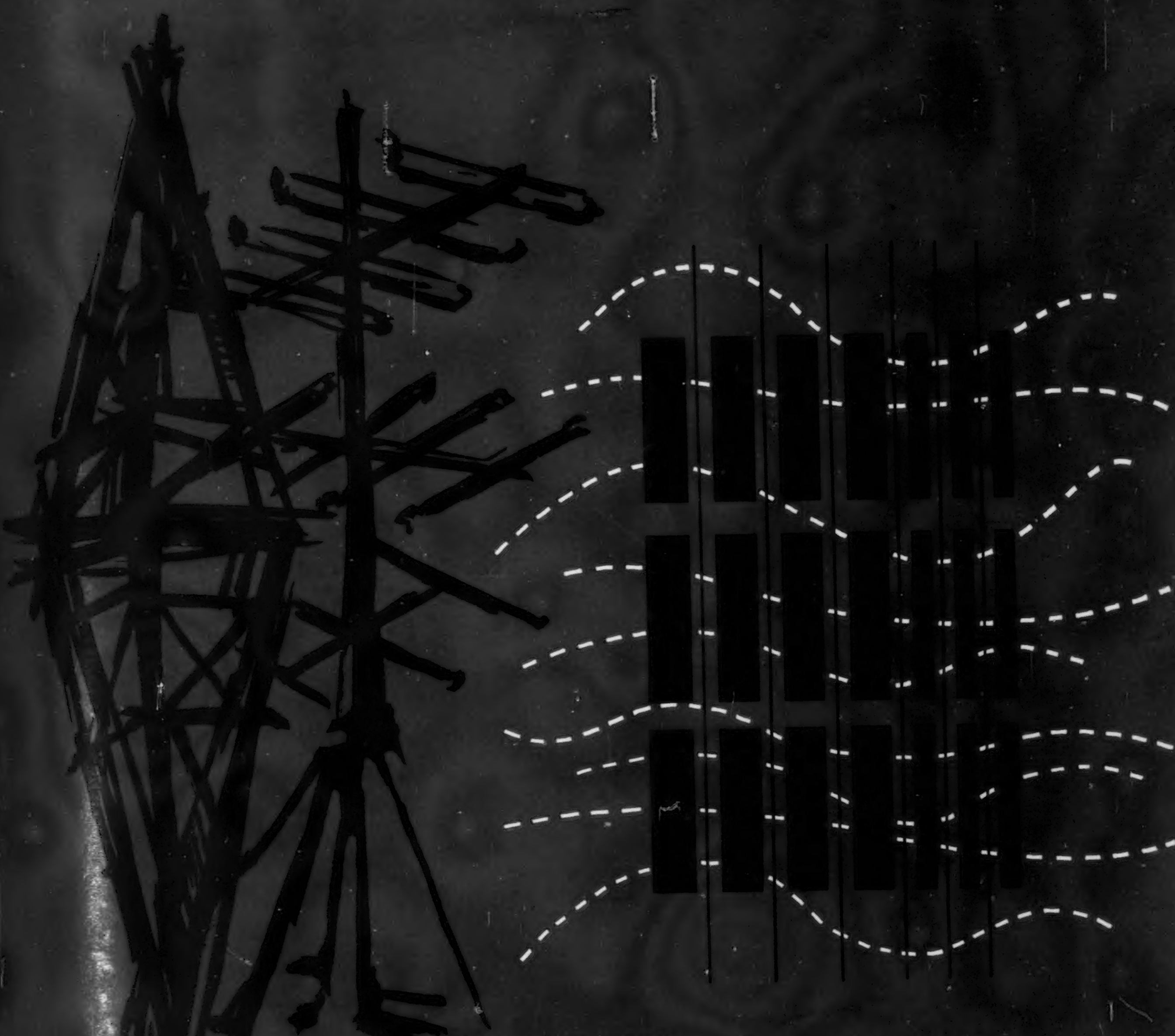
# BUSINESS HORIZONS



WINTER 1961

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## ARTICLES



## FEATURES



BUSINESS HORIZONS

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about the

AUTHOR | ARTICLE

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Mr. Kappel is Chairman of the Board of the American Telephone and Telegraph Company. A graduate of the University of Minnesota, he has received the honorary doctorate from several universities. He is the author of *Vitality in a Business Enterprise*, published in 1960.

*Good Profits Promote Progress*

It is a mistake to think of profit as merely the end result of business operations. Profit is an energizing force in good business performance. Too often we admire profit as a goal and deplore it as an achievement. While management cannot be dedicated solely to profit, separating profit from broader objectives is difficult indeed. "We must serve well to prosper. We must prosper to serve well." 21

LOUIS SHERE

An author and consultant, Mr. Shere is a recognized tax expert. He is a former Director of Tax Research for the U.S. Treasury and expert economist for the Council of Economic Advisers. He is currently Professor of Economics and Director of Tax Research, Indiana University.

*Suggestions for Federal Tax Reform*

Whatever their particular opinions, few people doubt the importance of tax reform. Here we are concerned not with the level of taxation or the strategy of tax reform, but with the long-run structure of federal, state, and local tax systems. The course of events compels us to compress greater achievements into less time; an overhaul of our tax machinery could greatly strengthen our efforts. 29

STANLEY H. RUTTENBERG

Mr. Ruttenberg is Director of Research for the AFL-CIO. During a distinguished career in the American labor movement, he has written for a wide range of publications and given expert testimony before several Congressional committees.

*Overhaul Needed in Overseas Business Investments*

The political and economic significance of our private overseas investment is inescapable. Will business policies be able to make the rapid adjustments required by changing world conditions? We can support rising expectations and adjust to social change without sacrificing the principles of free enterprise. Our business leadership will help determine whether we "break or bend" with the changing times. 43

LEON H. KEYSERLING

Mr. Keyserling is a former Chairman of the President's Council of Economic Advisers. His thoughts on economic affairs have been widely circulated in both printing and broadcasting media. He is currently a consulting economist and attorney in Washington, D.C. and the President of the Conference on Economic Progress.

*Growth Economics: The Crucial Issues*

The controversy over economic growth is more than a slugging match between "ins" and "outs." The President's economic advisers are on the right track, but they are a long way from the thought and action needed to meet our domestic needs and face our international perils. Some vital issues are being blurred; it might be better strategy to tell the American people what they may need to do in order to survive. 51

# PROFILES OF THE FUTURE

*LeRoy Collins*

## BROADCASTING | PRIVATE ENTERPRISE AND PUBLIC SERVICE

The task of the American broadcaster could be likened to that of a juggler who must keep five balls in the air simultaneously. The skill, ingenuity, and dexterity required by the juggler to perform his act without a bobble are exactly the qualities needed by the broadcaster for the successful operation of his radio or television station.

### THE TWO LOYALTIES

Broadcasting, unlike many other businesses and professions, is both a private enterprise and a public service operating under license from the federal government. Thus, it is constantly subjected to the pull of two different loyalties. To be successful, the broadcaster must not only make a reasonable profit on his rather substantial investment, but at the same time he is obliged to fulfill his social, moral, and legal responsibility by operating at all times in the public interest. It is his duty both to keep his station on the air and to provide—hour by hour, day in and day out, year after year—diversified programming that will meet the public's ever-changing desires and needs.

The thoughtful broadcaster honors this responsibility. He recognizes that America's goals are broadcasting's goals, that his own best interests as a licensed broadcaster are linked to the best interests of the public he serves. Broadcasting, the most powerful and effective means of mass communication ever known, must have both a strong conscience, and a desire to build the character, citizenship, and intellectual stature of the people, as well as to expand the gross national product. While short-run competitive advantage may be gained by disregarding the claims of conscience, neither profit nor self-respect will be served by such expediency in the long run.

Moreover, the responsible broadcaster realizes that if a minority should fail to meet this challenge, the "panacea" of government control, with which the industry has often been threatened, might well be imposed. These stricter government controls—however well intended—could only lead to chaos; the American people as well as the broadcaster would be entangled in red-tape restrictions that could spell an end to freedom. If broadcasters are to make outstanding contributions to the public good—as they must and do—they have to remain free; they must not be driven into economic and legal positions that would impose harmful restrictions upon them. A broadcaster can only serve if he is given the opportunity to do so.

It would be catastrophic indeed to impose any further government restrictions at this time. Technological ad-

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vances, especially in communications and in space exploration, have greatly broadened the broadcaster's opportunities for disseminating information and knowledge. Development of the communication satellite opens up new possibilities in the continuing effort to communicate among peoples of the world; our nationwide network of radio and television stations will in time be part of a communication system that reaches around the world. Simultaneous broadcasts in Chicago and Cairo, Trenton and Tokyo, and Miami and Madrid with instantaneous interpretation to surmount the language barrier are typical of what can be accomplished in the near future.

### PROGRAMMING

To meet his public service obligation, the broadcaster must devise and develop programming that will attract and stimulate listeners and viewers. This task would be simpler if ours were a static, uniform society; America, however, is a dynamic nation, and the interests of its people are constantly changing. Thus, the broadcaster must continually appraise his programming and periodically make the changes necessary to maintain the proper balance and diversity. He also must regularly develop new talent, search for new ideas, and keep posted on ideas and materials developed by others.

### EFFICIENT OPERATION

Closely linked with programming is another important element of the broadcaster's juggling act—the necessity of soliciting sponsor support in the form of advertising dollars. These represent his sole source of income, and he must secure sufficient revenue for not only his popular, large audience programming but also his programming for a more specialized, smaller audience. He must use ingenuity in developing sales plans that will appeal to local and national advertisers and must convince them that on-the-air advertising brings results superior to that placed in newspapers and other printed media.

Then, too, the broadcaster must operate his station efficiently in order to ensure that costs are far enough below income to provide the profit he needs to survive. While keeping payroll costs within manageable limits, he must still employ enough talented people to attract potential audiences and sponsors in a highly competitive situation. He must also weigh the cost of automatic equipment against the savings that may result from its use.

Quite often, the broadcaster's public service obligations pose a problem of station operation in that they run directly counter to the other factors that he must bear in mind at all times. As most broadcasters interpret it, this requirement means that a station must provide a certain amount of local programming, plus a good proportion of news and public affairs programming that originates both locally and nationally. In many cases, such programming is uneconomic in that it brings in less revenue than it costs to produce.

### FCC RULES

Finally, the broadcaster must adhere strictly to the technical rules and regulations laid down for his station's oper-

ation by the Federal Communications Commission.

The frequency spectrum is not, as many suppose, a boundless expanse of airwaves that can be used at will by broadcasters from coast to coast. In actuality, it is made up of many clearly defined "highways," the use of which is, in many cases, carefully restricted. Each broadcaster, for example, is assigned a frequency or channel on which to broadcast and can use it only during the hours that he is authorized to do so by the FCC. To prevent interference with the service of others, he must limit the power of his signal, and, in the case of many radio broadcasters, must make certain that his directional antenna is "on the beam."

Another FCC requirement is that broadcasters keep continuous and detailed logs on their entire operation. A broadcaster not only must list what he puts on the air and when, but also must report power failures and other interruptions to service along with the steps that were taken to correct them.

### THE INDUSTRY TODAY

Public service, diverse and balanced programming, solid sponsor support, efficient station operation in conformance with FCC regulations—these are the major elements of the broadcaster's juggling act. Putting and keeping all of them in the air is a demanding, full-time job.

Some sizable stations in large market areas are able to perform the task with relative ease. Because of their potentially large audiences, they are able to hire highly creative people to provide top-flight programming that attracts sponsors as well as listeners and viewers. Revenues are usually sufficient to

provide a substantial number of public affairs programs, and, because of their quality, many of these bring in sufficient revenue to cover their production costs.

The success of these relatively few large stations, unfortunately, tends to give the impression that all broadcasters are operating equally prosperously. The reverse, however, is often nearer the truth. Many television stations in these larger markets and a fair number of the 3,600 AM and 800 FM radio stations providing service to small communities find broadcasting to be a touch-and-go proposition. Proof of this is contained in the 1960 operating figures for the typical radio and television station. Revenue of the typical radio station amounted to $110,200 in 1960, but expenses ran to $101,800, leaving a profit before federal income taxes of $8,400, or 7.6 per cent on sales. Revenue for the typical television station in 1960 amounted to $904,500; expenses, however, totaled $765,300, leaving a profit of $139,200, or 15.4 per cent, again before federal income taxes. While there are obviously some very successful stations, these figures are convincing evidence that, on the whole, the broadcasting business is not an exceedingly profitable one.

Because of its tremendous impact on the public, the broadcasting industry is often thought to be much larger than it actually is. The entire industry employs only 87,000 persons, considerably less than the number on the payroll of some of the nation's larger corporations. Of these 87,000 persons, about 12,000 are employed in network operation. The rest, split about equally between radio and television, are employed by stations from coast to coast. The typical television station employs about 58 people. Very large stations employ as many as 250, while very small stations employ as few as 20. In radio, the typical station employs about 17 people. A very large station might employ 100, but the small one might have as few as 6.

The broadcaster who operates in a small market far removed from the larger metropolitan centers constantly faces the problem of hiring and keeping competent and qualified employees. People aspiring to careers in broadcasting often seek employment in New York or Hollywood, where most national programs originate, or in Chicago, Washington, and other large metropolitan centers. Actually, greater employment opportunities exist in the small station where, because of limited staffs, an employee can perform many varied tasks and thus acquire a more thorough grounding in the basic areas of broadcasting. Many talented employees, of course, gravitate to larger stations and to the networks where financial opportunities are greater. But for others, broadcasting in the smaller markets offers an interesting job, pleasant living conditions, and an integration into community activities to a degree that is not possible in large metropolitan centers.

Automation and its attendant changes are another major problem. Automation has proceeded rapidly in radio: It is now possible to operate a transmitter entirely by remote control; simplification of control board equipment enables a performer to operate the equipment while he is actually broadcasting; and automatic programming equipment makes it possible to tape much of a station's programming in advance and to control its air presentation by punched tapes or cards. As yet, the impact of automation on television has not been quite as dramatic. Even so, video-tape equipment is being used to provide flexibility in hundreds of television stations. Remote control of lights, cameras, sound booms, and other studio equipment is already possible, and some automatic programming equipment is now used in television operations. Remote control of TV transmitters is promised for the near future.

All of these changes add to management's problems. They may result in the displacement of people, and almost always do result in the combining of jobs that were formerly separate. The broadcaster is thus torn between his desire to use new devices and equipment that will improve efficiency and his concern for employees whose livelihood may be substantially changed.

CONFRONTED as they are by all of these complex forces applying to their operations, broadcasters have done and are doing a truly remarkable job. There is hardly a home in America that does not enjoy entertainment and educational experiences that only a few years ago would have been beyond imagination. In a short span of time, broadcasters have created some truly fine programming, and achievements that they are continually trying to better. They have constructed the most amazing means for mass communication the world has ever seen and done more to bring mankind closer together through information and understanding than any other single enterprise in history.

# *A new Business Horizons service*

We are pleased to announce that, beginning with the Spring, 1962 issue of *Business Horizons*, a new section dealing with business-related research will become one of our regular features. This innovation is in keeping with the heightened interest in research throughout the business community: Good form now has it that we should all pay our respects to research in passing; no annual report is complete without a section on research activity; and all good luncheon speakers must at least make an oblique reference to the value of research. Mention of research has, in fact, become one of the fundamental gambits in our occasional exercises in one-upmanship. Those of us who ply the academic trade have long been using this strategy, but its appearance in the realm of the practical businessman is of fairly recent origin.

Our interest in providing this new service for our readers, however, is based on a sober and constructive purpose. It has been our experience, unfortunately, that this general acceptance of the desirability, even the virtue, of research is not matched by ability to utilize it. Our intention is to aid the application of business-related research to business affairs.

One of the critical problems hampering this application is a basic information barrier. Two major factors are responsible for this barrier. First, there is the rapid expansion in the fund of knowledge, which imposes the simple physical problem of finding time to keep up with the information output. On balance, however, in spite of the burden it entails, this factor has its positive aspects. It stems, after all, from advances in our knowledge. But the second factor can in no sense be regarded as positive. This is the so-called "dilemma of specialization." In research work, as in production, efficiency is gained through the specialization of labor. But, like specialization in production, research specialization imposes a burden of coordination and communication, and this has only sporadically been recognized. The old saw about learning more and more about less and less contains an element of truth for society as well as for the individual.

Related to this problem of specialization is the fact that research boundaries drawn according to the traditional academic specialization of labor have little or no correspondence with problem boundaries defined by the practical situations out of which they grow. This means that the practitioner seeking to assemble the research bearing on a specific problem must hunt in the nooks and crannies of a number of the traditional disciplines.

These problems have been aptly summarized by Harold Guetzkow's phrase, "the conversion barrier." This refers to the immense difficulties encountered in attempts to relate the research orientation—with its necessary interest in theoretical abstraction and generalization—to specific applications, to real problems in concrete situations. The conversion barrier is more than a semantic problem, though it is that, too. It is a barrier that stems from the very structure of knowledge itself:

"The basic products of the social scientists are tested theories. . . . In its more rigorous form this basic knowledge consists of models of concepts in their interrelation to one another. Sometimes these concepts are well formulated, even operationalized as variables; sometimes the variables so developed are formally interrelated in systems as sets of mathematical equations. The theories of the social scientist are abstract and general, as they must be to have wide usefulness.

"The process of utilizing these theories is very different from the task of generating them. Applied knowledge is used toward particular ends, and the goals determine what information is relevant; theories are not valued of themselves, but only as they are applicable to the achievement of concrete, specific purposes. . . ."[1]

As if it were not enough that the

# RESEARCH CLEARINGHOUSE

*editor* James M. Patterson

frames of reference of the two worlds are basically different, it appears that the task of actually recognizing in the real world the conditions corresponding to the theoretical scheme is often much more difficult than the formulation and initial testing of the theory.

The net effect of these problems of finding and converting business-related research is that only an insignificant part of the increasing fund of social science knowledge has had any bearing on policy. It is perhaps even more significant that the problem is not going to correct itself. We are going to have to research, as it were, the process of research utilization. When Pendleton Herring was director of the Social Science Research Council, he suggested that we should begin to develop a breed of "social science technicians" professionally trained in the application of social science research to practical situations. Guetzkow, in the article cited earlier, argues for an expansion of the "middleman function," which should be differentiated from both the research role and the role of the practitioner. Perhaps these "social engineers" are the answer. If so, graduate schools seem to be slow in recognizing it. They are rightly troubled by the distinction between eclecticism and superficiality.

[1] Harold Guetzkow, "Conversion Barriers in Using the Social Sciences," *Administrative Quarterly*, IV (June, 1959), 71.

In the meantime, however, the show must go on. Decisions have to be made, capital has to be committed, markets must be entered, and employees have to be selected, trained, and welded together into effective organizations. What can be done *now* to bring research and practice closer together for the mutual benefit of both? Two moves seem obvious. First, we can improve our searching and reporting activities. This is no mean job, but it can be done. Secondly, and this is an even harder task, we can begin to hack away at the conversion barriers by encouraging certain broad-gauge researchers and practitioners to assume this middleman role.

Accordingly, in this new feature, we plan to record and classify significant business-related research wherever it is being conducted. In addition to systematically searching the various learned journals and published abstracts, *Business Horizons* plans to canvass key personnel in academic and corporate research centers, foundations, private firms, consulting organizations, advertising agencies, market research firms, and the like in an effort to discover and report on important business-related research in process.

Business-related research is conceived by *Business Horizons* to include all systematic inquiries having to do with identifying, classifying, measuring, and relating the variables or phenomena affecting the management of business firms. Presumably, this definition would encompass some research from all of the social sciences, including political science and history. It would also cover some research in mathematics, and perhaps even in certain branches of engineering. It is unlikely that it would include research from the natural or life sciences. To some extent, inclusion will have to be a matter of editorial judgment. But, while the term "business-related" will be interpreted broadly, there must be some empirical referent for the item to be included in our listing; pure speculations, ruminations, and pontifications do not fall within the meaning of research as conceived here.

To the end of tackling the conversion barrier, *Business Horizons* will invite a number of practical-minded researchers and research-minded practitioners to comment on the present state, significant trends, key problems, and practical implications of research in various areas such as leadership, buyer behavior, control, performance measurement, and decision making.

Hopefully, this new service of *Business Horizons* will represent a useful step in the direction of closing the gap between research and practice. The gap is wide; the time is late.

# READER AND EDITOR

## THE *NEW* BUSINESS HORIZONS

Every magazine likes to be distinguished not only for what it prints but for the way it looks. With this issue, both text page and cover of *Business Horizons* have been redesigned in what is *Horizons*' first major format change. Four distinctive colors have been chosen for the quarterly issues, and each cover will carry artwork that calls attention to a feature inside.

We hope our readers find the new format more pleasing to the eye and easier to read.

## A CONCEPT QUESTIONED

To The Editors:

I would like to call attention to the fact that a much used but quite meaningless concept has crept into the prevailing marketing ideology. I am referring to the concept of "utility." It is the fashion to claim that the marketing process creates utilities. Yet, strictly speaking, such a statement has no meaning whatsoever.

Involved is a quite elementary error of semantics. The word "utility" is a noun and implies some existent thing or existent quality. But these utility-things actually do not exist. All that occurs is a process – the process of consumption.

How often have we been told in professional meetings and journals that advertising benefits society by *creating* utilities? How often have we heard company representatives announce that their firms are *packaging* more utilities in their products today than they did yesterday. Indeed, if we look into the standard marketing textbooks or listen to the typical marketing teachers, we will even learn about the fine lines of distinction between form, place, ownership, and time utilities.

All such statements imply that utilities are some sort of "things." It is generally admitted that it is difficult to measure quantitatively these utility-things. They cannot be piled up physically in the four dimensional world of time and space. Rather, they are supposed to exist only in that gossamer fifth dimension of the human psyche.

Of course, this is all nonsense. These utility-things do not exist either in a four or five dimensional world.

To employ Elton Mayo's terminology, a man seeks to attain and maintain a "steady state" of physiological and psychological want equilibrium. The marketing *process* provides the individual with the goods and services to be used in the *process* of consumption, which is nothing more than the *process* of re-establishing the "steady state" of want equilibrium.

Now, it may be asked why all this fuss over a picayune matter of definition? Would we gain by discarding the noun utility and replacing it with some verb form referring to the consumption process?

The issue is not quite so petty. After all, one of the basic social justifications of the marketing process has been the belief that marketing creates utility. Such a justification is meaningless if the term utility is meaningless.

The marketing process may be considered socially desirable insofar as it aids the consumer in the consumption process of maintaining the "steady state" of want equilibrium. The important point is that it is also possible for the marketing process to disrupt the steady state and to generate dissatisfaction. This possibility is particularly true of advertising, to name one example.

One frequently stated justification of advertising is that it creates new wants. This would be a valid justification if there were such things as utilities. Creating new wants would then be synonymous with finding new ways by which individuals could pile up more utilities in the human psyche. Unfortunately, utilities do not exist, and inducing individuals to want more things may very well be considered an act that disrupts rather than creates "the good life."

Bernard Sarachek

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*Champaign, Illinois*

## FACULTY RE-EDUCATION

To The Editors:

The re-education of the business school faculty has been called the most pressing problem facing business education today. In light of the now widely accepted developments in the related fields of quantitative analysis and behavioral science, the traditionally trained faculty is, in many cases, no longer adequate.

One cannot, of course, designate a degree of re-education applicable to all faculty members: Some are well versed in both quantitative analysis and behavioral science; some do not teach in areas affected by the newer concepts; some need a great deal of work in quantitative analysis but little in behavioral science; and some have

so slight a professional interest that they will never spend the necessary time to gain proficiency in these fields. Thus, re-education needs range in degree from the person whose area is unaffected by the newer disciplines, but who should recognize their importance in education for business, to the person teaching in the functional areas, such as marketing or production, who must undertake a very difficult and lengthy program of education in both human behavior and quantitative analysis. Those facing the heavier education programs probably number less than one-half of the faculty.

The heart of the question, then, is how to accomplish the re-education of the minority of the faculty that faces the heaviest demands and is willing to meet them. Stated in these terms, perhaps the re-education process looks less ominous, but even with fewer numbers than supposed, the task facing these faculty members may be more difficult than at first imagined.

Professionally, the major share of a faculty member's time is devoted to teaching duties, curriculum matters, and research. The impact of the new disciplines is felt in each area. Through the years, he has taught what he and others considered a satisfactory set of courses. Today all the evidence indicates that his knowledge of his area must be supplemented by a proficiency in such unfamiliar fields as social psychology, cultural anthropology, or topics in modern mathematics. He can only admit that his courses are in some measure out of date.

Decisions on curriculum problems require a real understanding of the potential contributions in the allied fields. Without such knowledge it is virtually impossible to consider carefully such questions as: Should the requirements for entry to the business school be changed to expose the incoming student to behavioral sciences? What currently required courses should be dropped if several hours of mathematics or human behavior are added? How should the doctoral program or master's program be changed?

The third major activity of business school faculties is research. While the behavioral scientists have developed many potentially valuable concepts, their research has frequently been conducted in nonbusiness situations. For example, the famous "sleeper effect" of the source of communication, noted in work at Yale, was based on experiments with school children; research of this kind has great value in hypothesis generation, but this is its sole value. Applications in various business situations are necessary before the business faculty member can use the results of such research with confidence. For example, does the "sleeper effect" work in a situation where a person gathering advice on the purchase of a color television set consults advertising, consumer reports, and a neighbor who owns such a set? Do these sources exercise equal influence over time? Research involving questions such as these will probably have to be done by business faculties themselves since behavioral scientists have shown a remarkable antipathy to research in the business field.

The minority that faces the heavier re-education task is the core of any faculty. This is the group that the schools must build on—teachers in the basic functional areas of high professional interest, who are responsible for setting many of the policies and guiding much of the day-to-day activity of the school. How is the re-education of this group to be accomplished? It is too big a job for any single institution, even the Ford Foundation. Ford's role today seems mainly to be the creation of interest in these new areas; individuals and schools must carry through the re-education program.

While each school will solve the re-education problem in its own way, some general approaches do present themselves. In the earlier phases of faculty re-education, faculty seminars can be used. From the standpoint of stimulating interest, these should clearly show the relation of the new concepts and techniques to business administration. The people conducting the seminars could be experts in the fields studied, working closely with a business faculty group to ensure that the applicability of the material is made obvious. Some business schools have added mathematicians and psychologists to the faculty hoping that, simply by their presence, these experts would aid re-education, but the experience of these schools indicates that such a move is more beneficial when a specific program utilizing the talents of such persons is developed.

Beyond a rather basic level, faculty interests are likely to diverge, and individual study through reading or class attendance will become important. How can this be facilitated? The layman is likely to suggest temporary reduction in the number of hours taught. The coming shortage of college teachers, however, makes this an impossible solution for many.

If a general reduction of the number of hours of teaching is not possible, other methods of reducing the teaching load may be adopted. The sab-

batical leave is an ideal period for self-education. If one makes the heroic assumption that all schools have the 7-year cycle for sabbaticals and that there is an even distribution of faculty members in each year of the sabbatical cycle, then within the coming 3½-year period, one-half of the faculty members will be free to devote a year to their own work. It would represent a great step forward in introducing business faculty to the concepts of the new and important disciplines if faculty members were encouraged to use these sabbatical leaves for work in behavioral or quantitative areas. Load reduction may also take the form of a decrease in class size combined with generous assistance. Little benefit is gained if an instructor's teaching load is reduced from 12 to 9 hours, if the student load remains constant.

In addition, day-to-day activities may be facilitated in various ways to allow more time for reading or attending courses:

1 Schools may provide more graduate assistance for grading papers, aiding in research, or guiding discussion periods.

2 Teaching loads may be adjusted so that fewer separate class preparations are required. Instead of asking a man to teach four separate courses of 3 hours each, he could be given two sections of a 5-hour course and a section of a 2-hour course. This would reduce the number of preparations from four to two.

3 Preparations may be made easier by encouraging faculty members to specialize in a field. At some schools a teacher is expected to offer occasional courses in fields other than his own in order to maintain the proper degree of integration between business courses. While this is an excellent approach to the problem of integration, it may be too expensive in terms of faculty time. The faculty member who teaches an occasional course in another area must spend a disproportionately large amount of time on preparing for that course. The burden of integration can be shifted to the curriculum: Course requirements, course sequencing, and the offering of courses, such as business policy, can all be used to give an integrated approach to the study of business.

4 In many schools, committee work takes nearly as much time as that spent in class each week. For those engaged in study of these new fields, committee assignments could be reduced. Committee assignments in general could be reduced if the faculties were to set general policy limits and allow administrative personnel to operate freely within these limits. Faculty man-hours spent in committee meetings could be cut if the committees themselves were reduced in size.

If real progress is to be made in freeing faculty members for re-education purposes, a new philosophy is needed at the administration level. In many schools the administration draws heavily on faculty time; discussion of new programs, curriculum problems, research proposals, or even the time of day calls for the formation of a committee composed of "representatives of all interested groups." Faculty time has always been a school's most precious resource, but today the dimensions of the faculty re-education problem make the useful disposition of this time even more crucial. The following quotation from the Ford report is specific on this point:

"*Some business schools can show an excellent record in curriculum planning, in the development of case and other teaching materials, and in consulting and other service activities. But, in good part because of the time and energy devoted to these aspects of the school's program, research is neglected, and faculty members do not have the time and energy (and sometimes the training) to keep up with their respective business fields.*" [Robert A. Gordon and James E. Howell, *Higher Education for Business* (New York: Columbia University Press, 1959), p. 354.]

Re-education will make demands on both the teaching and administrative staffs. Faculty members must make again the sacrifices of a student, and to substitute the short-run gains to be had from consulting and publication for the longer-run gain of knowledge of the newly important sciences. By this, I do not suggest that these two activities be abandoned altogether: In the long run, consulting is invaluable for giving a faculty member a better understanding of his subject area; and business administration would certainly suffer if papers of substance were not published. Deans and review committees, however, must revise their bases for hiring and advancing faculty members. While a teacher's re-education commitment is not as concrete a measure as six or eight articles, those in charge of faculty promotions and additions have a responsibility to take it into consideration. Indeed, it is to their long-run advantage to do so.

The rewards of an intensive faculty re-education program more than justify the sacrifice. Effective introduction of the behavioral sciences and quantitative methods into the business school program would not only greatly modify individual course offerings and curricula, but would improve the training of future faculty members and ultimately result in both a higher quality of research and a higher caliber of students in business training. Business administration is a focal point for the interaction of such disciplines as economics, mathematics, psychology, and sociology; the well-trained business faculty can draw from these fields and, in turn, can enrich them with its own research. Under such conditions the business school of the future will be a major center of intellectual activity in the university.

CHARLES B. SAUNDERS

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**A CORRECTION**

IN THE article "What Management Games Do Best" by William R. Dill [*Business Horizons*, Fall, 1961], the two paragraphs on page 63 that begin "The right game . . ." and "Games can also . . ." were inadvertently misplaced. These should have followed the paragraph on page 64 that begins "We have progressed. . . ."

Education is the business of every man and woman in America. Indeed the future of our country may depend in a large measure on today's students who must assume the burdens and make the decisions of tomorrow! Today's leaders in business, in industry and those entrusted with the technical problems of government would be the first to attest to this. Our national future is linked more closely to higher education today than at any time in our history.

INDIANA UNIVERSITY, 11th in size of American Universities, has attained its present stature of excellence as a major university not only because of its superior faculty, its fine libraries and modern facilities, and the support given it by the State of Indiana, but also because of gifts of alumni and other thousands of friends who have had a long range view of the place of higher education in our future.

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# • • • • • • HIGHER EDUCATION

Frederick R. Kappel

# GOOD PROFITS promote PROGRESS



A few years ago, a group of Bell System managers made an intensive study of the relationship between profits and performance in American industry. They started with two questions: "Does profit do anything? Is it only a result or does it also cause things to happen that affect our economy?"

Their broad conclusion was that good profit, good business performance, and healthy economic progress all go together. But the men who made the study went further. Good profit, they suggested, does much more than parallel good performance.

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It is one of the essential factors in bringing good performance about. (The other essentials named were good management and a good product.) In other words, good profit is by no means merely a result; it is also causative, dynamic, and energizing.

These conclusions were based on the group's study of the actual case histories of companies in several industries. The weight of the evidence was that where profits have been relatively good, performance has also been relatively good, measured by several important criteria. Of the businesses analyzed, those that earned well had better growth records—with all that connotes of value delivered to consumers—than those that earned poorly. The more profitable companies put more investment (including more retained earnings) into new and im-

proved equipment; they did more research and more innovating; they offered better job opportunities; and they contributed more to community well-being.

Thus, the study group suggested that good profit should be regarded as a prime *cause* of economic and social progress. Profit, they felt, is not merely an end result of the business process, but a lively functional element that does indeed "cause things to happen."

### CONCEPTS OF PROFIT

The idea has had a mixed reception. Many people have said to me that they think it makes excellent sense; others have been critical. They have argued that, while good performance may indeed produce good profit, it is not demonstrable that good profit will generate good performance. Our study group, they contend, must have been putting its carts before its horses.

This critical reaction is not surprising. It is, after all, a new thought that profit can be causative in the sense suggested. For generations, profit has been regarded mainly as a result, a residue, a remainder, and this is still the popular notion. It is a notion derived, perhaps, from nothing more complicated than the classroom illustration that if a man grows an apple for 8 cents and sells it for 10, he is left with 2 cents profit. Or it may be that the classical economists of the last century are partly responsible. As they saw the matter, according to the *Encyclopaedia of the Social Sciences,*

> "There was first a separation between rent and a kind of gross income of the capitalist, as the business man was then more or less correctly called; subsequently the latter fund was divided between the capitalist and the laboring classes. Wages were supposed to be determined independently, the final share of the capitalist being left as a residuum."

Residuum—there is something lifeless and inert about the very word. It gives linguistic support to the view that the figures on the bottom line belong also at the bottom of our scale of values; and perhaps the typical form of income statement, showing profit at the bottom, further encourages this view. This is too bad, for as I see it, the fact that profit is something left over does not in any sense define its character. Its appearance as a remainder merely reflects its place in time, which is necessarily after the transactions that produced it. But this is no clue to its nature or potential.

Thinking about this, I was interested when someone the other day called to my attention the views of Francis Amasa Walker, as discussed by John Chamberlain in his book *The Roots of Capitalism.*[1] According to Chamberlain, Walker, a Civil War general, teacher at Yale, and later president of M.I.T., "isolated profit as the driving force of industrial progress." While Walker too saw profit as a result, he saw it also as something more. Profit, said Walker, is the special creation of the gifted enterpriser. He produces it "by his comprehension of the demands of the market; . . . by his organizing force and administrative ability; by his energy, economy, and prudence."[2] Thus, profit is more than a result; it is the instrument of dynamic change.

The classical concept of profit as mere residue suggests that when profit has been gained, its vitality ends. It is not useful to society; rather, it is likely to serve only the convenience and comfort of those who have possession of it. All this fits in with many people's feeling that while a little bit of profit may do no harm, profits for the most part are bad. To what degree public distrust of business profits may be derived from the concept of profit as a residue or any other economic theory, I am not able to say. More important is the fact that there is at present little or no theory of the kind that might dispel distrust. So far as I can see, profits are distrusted largely because the public sees them as a manifestation of economic power; because there is evidence every now and then that certain profits have not been hon-

[1] John Chamberlain, *The Roots of Capitalism* (Princeton: D. Van Nostrand Company, Inc., 1959), pp. 125-29.

[2] Francis A. Walker, *Political Economy* (2d ed.; New York: Henry Holt and Company, 1887), p. 241.

estly earned; and because of the belief that profit is often a reflection of the ability of some people to gain at others' expense. But these are political, ethical, and emotional considerations. They have nothing to do with any principle of business profit as such. It will be a pity, therefore, if we cannot gain acceptance for some view of profit other than one that, implicitly at any rate, deprecates its social usefulness. From the concept of profit as mere residue it is only a step to the moral contention that paucity of profit is a demonstration of virtue, and only one more step to the proposition that if scant profit is a mark of high integrity, then no profit at all must be a mark of the highest.

The danger is that noneconomic considerations may in the end determine what is to be done about profit. We need, on the one hand, a clear understanding that aberrations in business practice, unwarranted exercise of power, and the like are in no sense indicators of the function of profit. On the other hand, we need a concept of profit so satisfying that it will be impossible to identify ethical failure with failure of the profit principle.

Let us go back a moment now to Walker, who found in profit the driving force of industrial progress. Today one hears countless voices that seem to be saying much the same thing. I have in mind all the economists and journalists who echo and re-echo the refrain that "the profit motive" is the dynamo of enterprise. But for some reason, at least in this country, it seems to me there is much more applause for the profit motive than there is for profits. It is almost as though there were two kinds of thought: One has something in common with Walker's views, except that the modern stress, as I have said, is on the motive alone, whereas Walker did not stop there; the other, which is strengthened by the residue theory, if not derived from it, appraises profit with a wary eye, as something acceptable only when it is scant.

### THE PROFIT DILEMMA

In short, we are seriously at odds with ourselves about profits. Our attitude is: Hurrah for the profit motive and down with profits. Or as a Latin might put it, "Motive *si*, profit *no*." We want people to work for profits, but we are not at all sure that we want them to be earned. This is economic schizophrenia. It is absurd to hold that profit is a desirable incentive but a poor achievement. Men cannot work on the basis that it is right and necessary for them to pursue a goal that, when they reach it, will prove a sterile thing at best, and at worst a harmful one.

The Russians, I may remark, are in no such dilemma. They want profits, the genuine article, and not just "the profit motive." Witness this statement from the draft program of the Soviet Communist party as translated by Tass and printed in *The New York Times* on August 1, 1961: "It is necessary to promote profitable operation of enterprises, to work for lower production costs and higher profitability." (p. 13)

Wouldn't it be interesting some day to see a platform of the Republican or Democratic party calling for higher profitability? I am sure we can count on both parties to continue advocating prosperity, but it would be a great thing for the country if we might also find included—say in 1964—a recommendation in favor of higher profitability, the necessary ingredient of that prosperity.

### THE BENEFITS OF PROFIT

I have a good many reasons for believing that a plus in business profits fairly earned is a plus for everybody. *The profitable business has freedom to do what is right.* I did not say has freedom to throw money around. The business that is profitable can operate much more economically than the one that is not, for the profitable operation does not have to defer current expenditures that will improve long-run performance. The company that puts off doing what it ought to do, because it cannot afford it at the time, inevitably sacrifices long-run economies.

I could sum up much of what is in my mind by saying that good profits facilitate good management judgment, but since this statement needs particularizing, I shall try to illustrate.

## Training

Let us look first at the training of people. This is essential to the vitality of any business enterprise and its ability to contribute to economic progress. The selection of able people is a crucial task requiring thought, time, and money, and it is but the start of a long-range development process that calls for more of all three. I am not thinking of formal training procedures alone, but of the whole complex of effort needed to bring about conditions that encourage personal growth, inspire quality performance, and enable the individual to realize deep satisfaction in his work. The business that has adequate means available is far more likely, I think, to make the conscious and continuous effort needed than the business that is hard up.

There is growing conviction that the best way to test managerial talent is to give young people from the start assignments that truly challenge their capacity—in preference to training routines that impose a minimum of responsibility, fail to offer the trainee any sense of having a real job, bore him unutterably, and give him sore feet from standing around. One of the good arguments in favor of testing men early in their careers is that they will learn from their mistakes. In saying this, I am not advocating mistakes at any time; we have, however, to be realistic. If we are going to give people responsibility in this way, there are bound to be some errors and they are bound to cost money (albeit less than the cost of bigger errors the same people might make in later years if they did not have the judgment gained from making little ones). But if we cannot stand the cost of the small errors, we are not going to assign the responsibility. In other words, we are not going to do what we know we ought to do to build the future.

It may be said that these examples hardly provide all the evidence needed to support the case for healthy profit. I agree. Before offering more illustrations, however, let me remind the reader that these I have mentioned lie in an area of special importance for the future. With the advance of technology, there is an ever-growing need for the training and retraining of men and women in almost every phase of industry. People must learn to use new arts effectively, find new markets for new products and services, and function to best advantage in new forms of organization. In short, industry in the years ahead faces a tremendous task in education, and if industry cannot earn the means, the task is simply not going to be done well. To put it another way, the country is well aware that the schools face a problem of unprecedented scope. But as we all know, education is not completed at school; it only begins there. This is the recurrent theme of every college commencement, and with good reason. Starting where the schools leave off, industry must shoulder a considerable part of the total responsibility for future education—quite apart from its financial contributions to the schools.

## Physical Plant and Engineering

Another aspect of what I choose to call the vital or causative function of profit lies in the area of engineering and building plant facilities. Let us look at an example drawn from the telephone business, which must make heavy investment in physical plant in order to serve its customers.

A telephone engineer is called on to decide what size of telephone cable should be installed to serve a growing neighborhood. He knows it must serve perhaps 200 homes immediately. He is also reasonably confident that, in another couple of years, possibly 200 more homes will want service. Putting in a cable today that is big enough to serve all 400 homes will obviously cost more now than putting in one that will serve only 200. The carrying charges will be higher, too, of course. But if the engineer puts in the cable today that will serve only 200 homes, and another of equal size is needed two years later, the total cost and carrying charges will be considerably more in the long run.

So what will the engineer do?

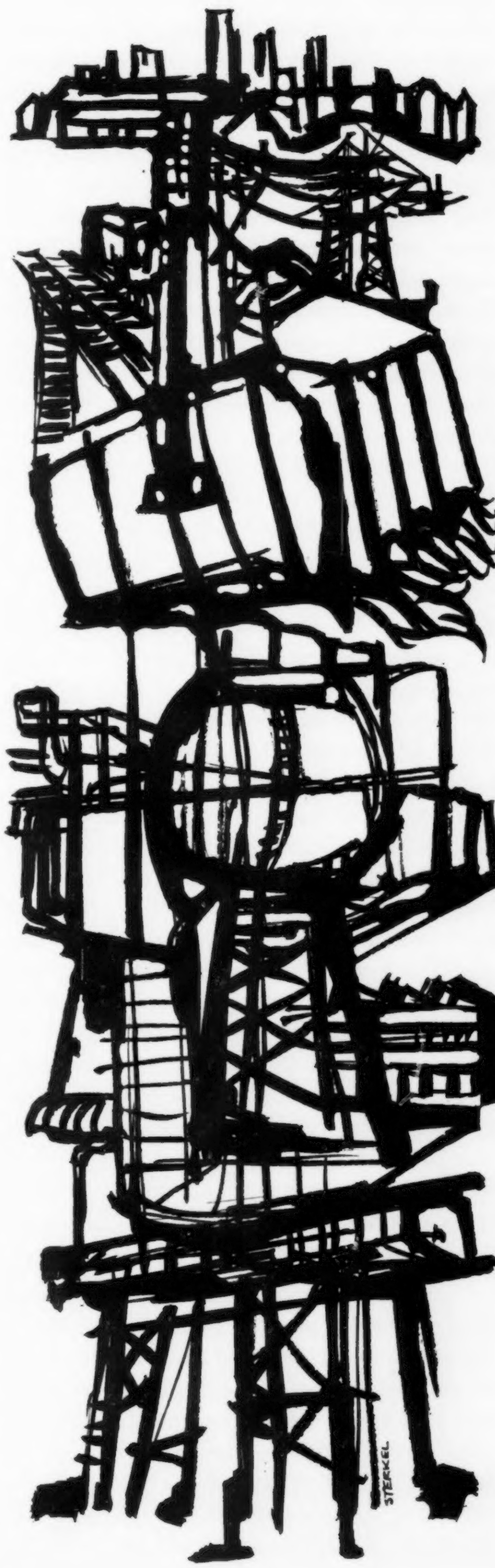
If the company he is working for is hard up, he will have to put in the smaller cable because that is cheaper *now*, even though it is obvious that this course will be more expensive in the end. If, however, the com-

pany is in good financial shape, if it can readily get the capital needed for investment in the larger cable, and if the general level of earnings permits absorbing the higher carrying cost of the bigger cable until its full capacity is utilized, then the engineer will be encouraged to install the bigger cable. Again I point out that good profit favors doing what ought to be done.

It is a commonplace that profit or the prospect of profit is necessary to attract capital. Less emphasized, but no less important, is the fact that healthy profit in countless instances promotes capital's effective and efficient application. The example I have cited is not an isolated instance; telephone people, and no doubt others in many different lines of business, have to make thousands of decisions like the one mentioned above. In the making of all such decisions, reasonable present prosperity helps to promote long-run economy and progress.

In the last year or so, much public attention has centered on the fact that a large proportion of America's industrial plant is growing old. Surveys that have been made indicate that about a third of it is now so old and inefficient that it ought to be scrapped. The Secretary of the Treasury has said that the average age of the nation's plant is twenty-four years, and the President has observed that some two-thirds of our machine tools are more than ten years old.

Aging plant is progressively more inefficient. We need to modernize our productive facilities to compete more effectively in world markets, help balance our international payments, and create job opportunities for our growing work force. Why then does industry retain so much old and inefficient plant? One important reason is that our tax laws do not allow industry enough depreciation expense, either in total or year by year. The result is understatement of true costs, corresponding overstatement of income, and, in consequence, a tax on capital. (Any levy on a proper expense that the law requires to be mislabeled as income must be a levy on capital; it cannot be anything else.) In any event, adequate depreciation plus adequate real profit has been made impossible.



I have been arguing my conviction that good profit works in favor of productive efficiency. It seems to me that the apprehensions about inadequate depreciation and the movement to find some remedy support this argument. In essence, what we have here is a growing concern that capable and effective businesses should be able to earn the real profits they need in order to become more productive. Maybe some people in government have not thought the matter through in this way; if they have not, I wish they would. Knowing the problem for what it really is might lead also to better understanding of the function of profit in other respects.

## LEAN LEAVINGS NOT ENOUGH

The main effort in this article has been to suggest the meaning of a concept that says that profit is not something merely residual, but is causative and energizing. At this point, however, someone may well say, "Look here, this is all very well, but are you really talking about profit per se and how much of it there ought to be? It seems to me you are talking rather about some of the things a well-managed business needs to do *before* it makes a profit—before it is able to deposit that residue. There are other accomplishments that are also important: good wages and working conditions, for instance, safe working practices, research and development, the introduction of new products and services, alertness to consumer needs, and so on. So long as you accomplish these and still have something left over, this is what really counts, isn't it? And where is your proof that the residue, the profit, needs to be more than minimal?"

I can only answer that last question from actual experience as a manager, and this experience has convinced me that the quality of management performance is influenced in every aspect by the prospect of good earnings on the one hand, or of lean leavings on the other. For evidence, I have to turn again to events in the Bell System. This is not intended as special pleading, and I hope it will not be so interpreted. The fact is simply that to speak from experience, it is necessary to refer to it.

Our over-all earnings situation in the years soon after the war was poor. In the early 1950's, there was a slight improvement, and in the last few years there has been further improvement. What one may trace rather easily, as earnings have risen, is an acceleration of projects that markedly increase the quality, dependability, and convenience of the service rendered.

For example, we measure the quality of telephone transmission in terms of how people might hear each other if they were conversing in a quiet open field. In 1950, transmission on the average long distance call was as though the talkers were standing 15 feet apart. In the ten years following, this distance was reduced some 20 per cent—to about 12 feet. But with a better profit margin at hand, we are now working on a program to cut the distance down to less than 5 feet by 1970. This will make an enormous difference in the ease of conversation.

Perhaps it has been noticed also that as Bell System earnings improved in the later 1950's, there came a succession of new telephone instruments and systems for homes and offices. Direct distance dialing spread rapidly so that today about three-quarters of all our customers can dial their own calls to all parts of the nation. Ocean telephone cables to Europe, Alaska, and Hawaii have resulted in a great improvement in overseas services.

Today a program is under way to sharply reduce the occasions when people wanting to telephone in the busier periods of the day will find no circuits available. Another important project is construction of a bomb-resistant underground communications system across the continent. Our direct distance dialing program is proceeding on a schedule that will make such calling available to nearly every Bell System customer in the next four years. Means for automatically identifying the calling number are being installed under an accelerated program. Data-Phone services, which enable machines to communicate with other machines through the regular nation-wide telephone network, are being rapidly extended. Mil-

lions of dollars are being spent for the development of communications satellites that may permit global communications, including television and data as well as voice transmission, on a scale hitherto impossible.

Were the profits of the Bell System today no better than they were in the 1940's and well into the 1950's, it would be impossible for us to push ahead with anything like the same vigor. And if we could not maintain good earnings, we would necessarily have to put a checkrein on forward undertakings. Prudence would demand this.

Not that profit can or ever should be assured. It must be worked for and earned in every sense of the word. But if the ultimate end in sight is meager, few managers will bend extra effort to develop and proceed with new and useful long-range projects that increase current costs, or build additional excellence into their product, or take special pains with their maintenance, or spend either a million dollars or a hundred to make their plant and facilities more efficient. More likely, they will feel pressed to move in the reverse direction. They may compromise on quality; they may skimp on maintenance, or even do none for as long as possible. They may rely protractedly on the outmoded and outworn. Against his better judgment, against all his instincts to do the job well, the manager is pushed into ill-advised corner-cutting, into expedients and substitutes, into deletions and omissions that may not show immediately but will ultimately sap the long-run vigor and strength of the enterprise. In short, if he has no hope of prosperity by the means that will most benefit his customers and his company, which is to give real value and earn an equivalent reward, he is forced into the situation of trying to keep integrity in his financial statements by taking it away from his business.

### THE BROADER VIEW

Earlier in this article I put some stress on the difficulties we get into if we admire profit



as a goal but deplore it as an achievement. We cannot be half for profit and half against it. I wonder if the reason some of the critics of profit get into this situation may not be that they see business managers as dedicated *solely* to profit. Perhaps some managers are so dedicated. However, my observation is that most of them have a broader view. In a business like the one I am in, the question is ever present, "Which comes first, service or profits?" Our license, of course, is only to serve, nothing else. But to answer the question by separating the one from the other is difficult indeed. Years ago, the answer was given in these words, and I find it hard to improve them: "We must serve well to prosper. We must prosper to serve well."

I have omitted from this discussion such an obvious point as the fact that prosperity pays taxes. All it appears necessary to say is that if the government wants revenues, the government will do more than give lip service to the profit goal—it will really encourage the making of real profits, and rejoice in the result.

No discussion of business profits can be conclusive. But to refer again to the study mentioned at the start, where there is overwhelming evidence that profit, performance, and progress are intimately linked, may there not be wisdom in accepting the likelihood that profit is in fact an essential contributing factor? I realize that economics is not an exact science. By the same token, however, it seems necessary to say that no theory that denies a causative, creative role to business profits can be taken as definitive. From experience and observation, I am persuaded that good profits not only accompany and make manifest sound progress, but do in fact make important contributions to it, and must be regarded as essential to promote economic growth and the achievement of desirable economic goals. Only an economy in which industry and government see eye to eye on this, and work in harmony to nourish business profit, will realize its full potential in creating productive efficiency, in delivering the greatest value to the consuming public, and in raising living standards.



AS THE Spanish proverb says, "He who would bring home the wealth of the Indies must carry the wealth of the Indies with him." So it is in traveling: a man must carry knowledge with him, if he would bring home knowledge.

—SAMUEL JOHNSON
*Boswell's Life of Johnson*

Louis Shere

# *suggestions for* FEDERAL TAX REFORMS



If anyone doubts the importance of tax reform for the United States of 1961, let him read the thousands and thousands of pages of testimony presented to the Congress in recent years.[1] With such a stockpile of evidence and advice already at hand, it is appropriate to inquire what, if anything, is to be gained by adding to it. One can only hope that, during one of the inevitable shifts in the political and economic environment, reformulations of evidence and argument will set in motion the machinery of tax legislation.

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I am basically concerned here with the long-run structure of the federal, state, and local tax systems, rather than with the level

[1] A sampling of this testimony might include: *Federal Tax Policy for Economic Growth and Stability*, Joint Committee on the Economic Report (Washington: U.S. Gov't Printing Office, 1955), 929 pp.;

*Economic Report of the President*, Hearings before the Joint Economic Committee (January, 1957), 792 pp. (see pp. 423-72 for the author's study "Federal Tax Revision to Promote Economic Growth and Stability");

*Topics Pertaining to the General Revision of the Internal Revenue Code*, Hearings before the Committee on Ways and Means (January-February, 1958), 3,588 pp.;

*Compendium of Papers on Broadening the Tax Base*, Committee on Ways and Means (November, 1959), 2,382 pp.;

*The 1961 Tax Recommendations of the President*, Hearings before the Committee on Ways and Means (May-June, 1961), 3,612 pp.

of taxation and the strategy of tax reform. There is no escape, however, from these more controversial aspects of the problem. As everyone knows, it is easier to revise a tax system if, concurrently, it is feasible to reduce taxes on some taxpayers without compensatory increases on others; and it is still easier, if practical, to reduce everybody's taxes.

Politically, it may be necessary to dangle before the electors the prospects of tax reform that would help to reduce taxes, reduce the public debt, increase grants and other payments to state and local units of government, catch up on the billions of essential public expenditures still a backlog from the great depression and war, reduce the inequality in living standards, level the inequalities between the less and the more developed countries, and, above all, increase expenditures to better safeguard freedom. All this may be attainable both economically and politically, with or without tax reform, without inflation, and, less certainly, without prejudice to economic growth. All this is possible, not pure fantasy, if only we could control *time*. Politicians are even more fuzzy than economists in handling this critically important element.



## THE STATE OF THE ECONOMY

The American economy is virile. Despite all the lamenting over its unsatisfactory pace of development in the post-World War II period, its performance should not cause us to hang our heads in shame. You and I may not be proud of the output mix—of the quantities of inputs dedicated, say, to the output of liquor or to the proliferation of automobile models. We might have preferred more investment in plant, machines, equipment, and people (through health and education programs), all of which would have contributed more to a good life and a better opportunity to live it. But we cannot charge these shortfalls to stagnation of the American economy. Rather, they reflect a failure in political and economic management, an entirely different matter with significant import for future fiscal policy.

So long as cyclical fluctuations prevail, a substantial gap will show between the actual output of an economy over a span of years, and any reasonably posited bench mark of full capacity. The recent debate on the post-World War II performance of the American economy is more sophisticated than the preceding observation implies. The difference in interpretation of the facts results from an attempt to read, from the performance at peak points, whether a secular deterioration is under way or whether the cycle-to-cycle differences, in the shortfall of actual peak from potential capacity, reflect no more than the usual variations in the patterns of different business cycles. For scientific results, how many such points are needed to establish a trend? Perhaps we can agree that the correct answer is more points than the three that are available. The fourth point, which is in the making, will not help, for, as always, it will be clearer to some than others that special forces are operating to re-establish the respectability of the American economy's performance. The peak is now patiently expected at or before the end of 1962.

If, in fact, another ex post look shows that the American economy was stunted by excessive taxation over the whole of the post-World War II period, consideration should be given to removing this obstacle or at least to offsetting it by alternative measures: easier money, stepped-up public expenditures, and so forth. Increased emphasis on growth, as such a reoriented combination of economic policies implies, could lead to more inflation with serious domestic and international complications. In planning tax reform, the critical question is whether inflation can be kept in bounds if the mix of policies to contain it is to include a lower level of taxation.

## ROLE OF THE LATENT SURPLUS

Whether a latent surplus[2] should play any part in changing the level of taxation in tax

reform depends, again, on time. In 1957, I stressed the significance of a latent surplus. Optimistically, I believed that if an improvement in the international situation made it practical to hold the line on defense expenditures, we might catch up substantially on essential nondefense expenditures and reduce taxes without inflation. This optimism was based on the well-known capacity of the American economy to expand and, with it, the public revenues at an even faster rate, coupled with faith in our political maturity and our ability to legislate on the essential public programs no faster than the economy's ability to provide the resources required to implement them. I realized less fully than now the urgency for massive assistance to the less developed and densely populated areas of the world, particularly if communist activity increases.

Beyond this, perhaps all of us still fail to realize the importance of speeding up domestic programs designed to strengthen the economy and to wipe out pockets of poverty and disease. And the international situation has worsened, not improved. It has become increasingly clear that the course of events compels us to compress greater achievements into shorter periods of time. This has a significant impact for American tax policy. There is now less need, not more need, to stress the potential of the latent surplus. Indeed, if we do what we should do in relation to the rest of the world—keep our powder dry, renew decayed spots, and invigorate the American economy by providing needed public facilities—the latent surplus will vanish and more; higher taxes may well be required for a substantial period. It all depends on how quickly some of the essential programs will need to be activated. If public expenditures can be stretched over long periods of time, the latent surplus becomes more distinct and looms larger, and with it the prospects for tax reduction. But forces beyond our control are at work; these may call for huge outlays in a year, instead of five years, and in a decade, instead of five decades. Politically, a step-up of expenditures designed to improve international conditions tends to interlock with pressures for higher expenditures on domestic programs. The control of the budget becomes difficult only when circumstances require that some sector suffer at the expense of another.

This is no time for timidity. The affluent consumer in the luxurious domain of the private sector may need to be asked to give something to the public sector in the form of higher taxes as their contribution to a higher rate of saving, investment, and growth. It will require political courage to ask them for this adjustment in the disposition of their income—more courage than to assure them that all can be left to a latent surplus.

The high level of the combined governmental budgets in the United States throughout the post-World War II period has been a significant expansionary force. Those who fear inflation have rightly fixed their sights on the persistent upward trend of these budgets and marked them for careful scrutiny. These high-level budgets are expansionary even when they are balanced, but particularly when they are not. The stimulation provided by the high-level budgets may well have more than offset the budgetary surpluses and the depressive impact of high taxes, which over the same period ranged from over 22½ per cent to over 30 per cent of net national product (gross national product less capital consumption) and ex-

[2] The concept of a latent surplus relates to the long-run outlook for the budget. It is—and for present purposes can remain—loosely defined. On the receipts side, the existing tax structure and rates are assumed. On the expenditures side, the view most favorable to the emergence of the latent surplus is that public expenditures will grow secularly at about the same rate as GNP. A less favorable view is that, under prevailing national and international pressures, public expenditures will for some time increase at a faster rate than GNP. Such a rate of expenditures may well overtake the rate of increase in revenues, which normally exceeds that of GNP.

Anything that has an adverse effect on the rate of increase in GNP darkens the outlook for an emerging surplus, because the shortfalls of GNP affect the receipts side more than the expenditures side. We still live in a world where the business cycle must be reckoned with; we may have trapped it but have we tamed it? Instability continues to be the arch enemy of growth in GNP.

ceeded 25 per cent in all but three of the fifteen postwar years.[3]

The latent surplus is no myth; its importance is not to be underestimated. But it will vary with projections of gross national product, which are affected by many factors: the rate of increase in the labor force, the length of the work week, the rate of improvement in productivity, and so forth. It will vary also with projections of public expenditures based upon existing and prospective legislation. Small changes in the assumptions sometimes result in large changes in long-term projections; this tends to undermine confidence in their usefulness as policy guides. I point this out, not to emphasize the whimsical nature of the latent surplus, but to stress that it is, or at least that it may become, critically important to shift policy deliberately so as to accomplish more quickly what in less urgent circumstances would be done more gradually. This need for shifting policy is the arch enemy of the latent surplus. In fact, the level of taxation may need to be raised to avoid substantial deficits and inflation. If it is not politically wise to say this, then at least let us refrain from overemphasizing the potency of the latent surplus, particularly without specifications in regard to timing.

## TAX REFORM AND GROWTH

The general import and conclusion of these introductory remarks is that U.S. tax reform, if undertaken in the near future, will need to travel the hard road of revenue balance within the system or even the harder road of tax increases, rather than the easy road of tax reduction.

Fortunately, we begin the task of federal tax reform with a basic structure that, for all its shortcomings, has not been a major obstacle to growth and stability. I expect this appraisal to be challenged sharply by all who stress its complexity and the creaks and pains in its every joint and muscle. A tax system (federal, state, or local) that relies on income and profits taxes to the extent of 55 per cent or more is highly responsive to economic fluctuations. The quality of our tax system ranks high on this score by comparison with most, if not all, other countries.

Since the structure, strength, and salient features of the American tax system are on the whole sound and satisfactory, we need only make some major adjustments, the better to fulfill generally accepted and sometimes conflicting goals, such as the promotion of growth and stability, simplification of administration and compliance, reduction of inequalities in wealth and income, elimination of discrimination, and so forth. Although we have already attained a high level of affluence, top priority should perhaps be assigned to increasing the rate of growth if there is a conflict in goals. Our hand is forced in this choice, for we are in competition with a regimented economic system under guidance that threatens to destroy us and to capture the uncommitted world. We must be assured of resources adequate to defend freedom, preserve our standard of living, and erase pockets of poverty at home and widespread poverty abroad.

We cannot agree on the attainable rate of growth, largely because we cannot agree on the possibilities of cutting into expected rates of improvement in our living standards and because we do not realize clearly that arithmetic imposes inflexible limitations on the rate of growth of an already highly industrialized society. We agree, however, that active policies should be pursued to get a higher rate of increase in output, particularly the type required to promote growth. Tax reform can play an important role in such policies.

I have so far considered the over-all fed-

[3] The view that rising public expenditures, even when balanced by revenues and to some extent more than balanced, can result in a significant increase in the nation's marginal propensity to spend is based on the elementary consideration that government is a more certain and rapid spender than individuals and businesses. But more proof is needed to substantiate this position. We do not know the change in distribution of disposable income that resulted from the increased outflow of government payments and the increased inflow of tax revenues; nor do we know much more than the direction of the incentive effects of the higher taxes associated with the higher level of expenditures. The conclusion reached is in the nature of a guess, but I believe that it is not a wild guess.

eral, state, and local tax system in order to provide an appropriate background for the appraisal of specific proposals. Now I am compelled by space limitations to confine my remarks to federal tax reform. Actually, no radical change in the tax systems of the state and local governments is in prospect for the near future. For reform of these systems, we must continue to look to the spadework of thousands of governmental units and leadership of the recently created coordinating Advisory Commission on Intergovernmental Relations. But I cannot leave the state and local arena without a comment on the property tax. A tax that yields nearly $17 billion or 15 per cent of all tax revenue in the United States should not be allowed to flounder in weak and discriminatory administration. If the independence of local government is to be preserved, then more equitable standards of assessment, collection, and general administration of the property tax must become a reality, not a subject of perpetual debate and despair. If the states cannot assume responsibility for this reform by themselves, they should try to enlist the help of the federal government and its strong tax administrative services. Good administration of the property tax is not unrelated to improved administration of the income tax, federal as well as state.

## FEDERAL REFORM SUGGESTIONS

After an abortive start in 1961, federal tax reform has been put on the agenda for 1962. I do not intend to write the 1962 federal tax bill or to review systematically the President's 1961 recommendations. Instead, I plan to discuss a few of the more important incremental changes; each change, particularly in combination with the others, would significantly improve the federal tax system. The approach is selective rather than comprehensive, and no importance should be attached to the order of the items.

### Depreciation

It comes as something of a surprise to learn that, after the postwar burst of investment, our plant is still old and our machinery and equipment are aging at a pace that threatens our competitive position in world markets and our aspirations for security, expanding employment opportunities, and rising living standards.

All nations, the more and the less industrialized, have adopted one form or another of accelerated depreciation to stimulate investment and thereby to speed up the rate of economic development. In 1954, the United States joined this movement. While the primary objective was growth, accelerated depreciation also mitigated some of the tax problems that had their origin in inflation. In a period of rising prices, it is impossible to replace the assets of a going concern out of depreciation funds alone if depreciation is limited to original cost.[4] In a dynamic economy, with attending price in-

[4] I agree with my colleague James G. Witte, who would qualify this statement as follows:

"There are at least two major qualifications to the familiar allegation that depreciation charges are inadequate to enable firms to recover their original capital costs in periods of rising prices. First, when positive net investment is taking place each year, as it must in a growing economy, there is a continual reduction in the average age of the capital stock, although the force of this point might be reduced by the recognition of the possibility of unanticipated obsolescence. If depreciation charges are based on one of the acceptable formulae which employ original cost as a base, then depreciation charges must recover original costs prior to the date of scheduled replacement. In a steadily growing economy the social accounting item called 'capital consumption allowances' must therefore be greater than actual replacement expenditures if the trend of prices is constant, and can be equal to or less than replacement expenditures only if there is an upward trend in prices. Not any increase in prices is sufficient, however, to eliminate this gap between original cost depreciation charges and current replacement costs; the rate of inflation must be above some critical value.

"Second, what is the meaning of replacement or capital maintenance? If one follows J. R. Hicks in defining income as the highest rate of consumption consistent with the maintenance intact of one's capacity to consume at this rate in the future, then capital maintenance consists of replacing existing assets with assets of the same productivity. In a technically progressive economy, the quality of capital goods improves over time, which implies that the real cost of capital maintenance declines with the passage of time. Unless the rate of inflation of the prices of capital goods is higher than the rate of decline of the real cost of capital maintenance, depreciation charges based on orginal cost are adequate to provide for capital maintenance."

stability, the longer the write-off period, the greater the chance that normal depreciation will fail to match real depreciation. While falling short of "latitude," the 1954 legislation (which allowed, for example, the declining balance method at twice the straight-line rate) met part of businessmen's demand for the privilege to expense capital outlays. It also eliminated much of the bickering with the Treasury.

While complete latitude would have provided the maximum incentive to investment, particularly on the longer-lived assets where risks are greatest, it is important to consider that if revenues were to be protected, higher taxes on taxpayers not favorably affected by liberalized depreciation would be needed.[5] This, in turn, would offset much of the stimulus to investment brought about by the higher depreciation rates. Over a period of transition to the new depreciation system, liberalized depreciation involves a substantial revenue loss or a permanent deferral of taxes. It also tends toward instability; the pattern of tax reduction implied in liberalized depreciation is perverse, since investment expands more in prosperity than in recession.

Between 1954 and 1961, the merits of the 1954 liberalization were seriously debated, with not a few proponents for an equivalent uniform reduction of the corporate income tax or even of other taxes. The turn toward an investment incentive plan in 1961 stemmed from a pessimistic reading of the performance of the American economy in the latter part of the 1950's.[6] The rate of growth declined below historic levels, particularly below the growth rate of the postwar years. This is alarming, even if we cannot be sure that the decline constitutes a downtrend. In circumstances of unabsorbed unemployed, balance of payments difficulties, and a deterioration in international affairs that requires increased resources for defense and the preservation of living standards, nobody is disposed to criticize the President for pointing to the potential and imminent danger from a slowdown in the rate of our economic growth.

The failure of the Congress to respond, despite official warnings that "there is not a moment to lose," stems from disagreement

[5] Actually, liberalized depreciation would require *more* than replacement of the revenue. If the economy is in stable equilibrium and is to remain so after liberalization of depreciation, and if public expenditures are not to be reduced, then private consumption must be reduced by the amount of the increase in investment. This requires an increase in taxes that is greater than the increase in investment, because some of the taxes will cut savings rather than consumption. How much greater depends upon the type of tax used to recoup the revenue and to maintain stability. The more regressive the impact of the tax, the less will taxes need to exceed the increase in investment. For practical reasons, it may be necessary to replace the revenue loss with taxes that more nearly approximate the incidence of the revenue lost, in which case the required increase in the level of taxation could turn out to be substantial.

[6] This plan was to take the form of a tax credit of 15 per cent of all new plant and equipment investment expenditures in excess of current depreciation allowances; 6 per cent of such expenditures below this level but in excess of 50 per cent of depreciation allowances; and with 10 per cent on the first $5,000 of new investment as a minimum credit. An over-all limitation did not permit the credit to reduce tax liability in any one year by more than 30 per cent. The credit was to be separate from and in addition to depreciation of the eligible new investment at cost. It applied only to assets with a life of six years or more. Investments by public utilities, other than transportation, and investment in residential construction (including apartments and hotels) were not eligible.

primarily with business, but also among the experts over technical aspects of the President's proposal. Stripped of detail, these differences seem to boil down to a distaste for two aspects of the recommended formula: the fact that it discriminated in favor of new and rapidly growing businesses, as opposed to slowly growing and established businesses; and that it also favored those established businesses that invested more than one-half of their ordinary depreciation allowances, as opposed to those that invested less. Business resented what it regarded as an attempt by government to interfere with management decisions to invest or not to invest, much as it resented the 1936-39 undistributed profits tax pressures on dividend policy. It was argued, with considerable plausibility, that across-the-board liberalized depreciation on the 1954 pattern would be more equitable and less complex. Less convincing was the testimony to the effect that, dollar for dollar of revenue cost, the proposal would also be less efficient than liberalized depreciation and that it would do less for small business.

These less convincing arguments are based on alleged facts, which presumably are in the custody of a privileged or diligent few. The alleged facts are these:

*First,* small business receives less favorable depreciation rates because it is compelled to go by the Treasury's cruel rule book. Big business, on the other hand, can and does get better rates on the basis of expensive evidence that it alone can afford to prepare. The first requirement, then, is to reform the Treasury's alleged discriminatory depreciation practices and to align the rates between small and big business.

*Second,* business tends to invest all or a fixed percentage of its depreciation reserves more or less mechanically on some rule-of-thumb basis. If this is so, the President's formula is inefficient. It calls for a tax credit instead of an increase in the allowable deductions from gross income. Moreover, this tax credit is in addition to ordinary cost depreciation; hence, it has the effect of forgiving the business (individuals, partnerships, and corporations) part of its tax liability. If, instead, the extra depreciation took the form of a deduction in excess of 100 per cent of cost, this too would reduce taxes permanently—but with this alleged difference: If extra depreciation takes the form of a deduction from gross income, then the high-salaried business managers, operating their rule of thumb, would automatically send all or a fixed proportion of reserves into investment, but if the increased depreciation takes the form of a tax credit, taxes are affected but the depreciation reserves are not. Therefore, according to the rule-of-thumb theory, investment is not affected. The thumb is frustrated. One who is not privileged to know precisely how business management really operates can only express skepticism. Fact or allegation, such considerations helped to destroy the President's proposal.

The major decision to further liberalize the 1954 liberalized depreciation was doubtless sound. One can be less certain about the lesser decision to breach the principle of limiting depreciation to 100 per cent of original cost, but a combination of considerations could justify it: the urgent need to step up the rate of investment and a belief that the extra stimulus would be substantial. Beyond that, it is easy to exaggerate marginal differences from alternative formulas, such as the impact on differential prices and so forth.

### Corporation Income Tax

If taxes on business are reduced selectively through stepped-up depreciation, as was done in 1954 and recommended in 1961, this should not be left out of consideration when tax rates are being reviewed. Marginal rates remain unaffected, but the tax base is shrunk by liberalized depreciation. Taxes are reduced unless the tax base is broadened to compensate. This involves reducing or eliminating other deductions. Alternatively, the tax rates must be raised somewhere else.

The considerations that point to the need for a further liberalization of depreciation point also to a need for reduction of the mar-

ginal corporate rates. I suggest that the 52 per cent rate be reduced to 50 per cent and the applicability of the 30 per cent marginal rate be extended from $25,000 to, say, $100,000. In addition, a step should be taken in the direction of reducing double taxation of distributed corporate profits.

Double taxation is significant primarily because it affects investment incentives. With excessively high individual and high corporate income tax rates, the wealthy investor is left little return, particularly when the investment is risky. For political reasons alone, the approach to the elimination of double taxation will need to be gradual. However, economic considerations are in harmony with this approach. An excessively rapid shift from taxes that impinge more directly upon savings and investment to those that impinge more directly upon consumption could stifle our high output economy. It seems to me desirable to tackle the double taxation problem by replacing the present defective $50-dividend exclusion and 4 per cent tax credit[7] with a new deduction under the corporate income tax of 10 per cent of dividends paid out. The deductions should be raised gradually to 20 per cent as circumstances permit. Thus double taxation would be substantially mitigated; I do not, however, expect it to be eliminated completely. My preference for a deduction for the corporation, instead of a credit for the individual dividend recipient, stems from the uncertainty of the incidence of the corporation income tax. There is little point in relieving the dividend recipients from a burden that they may not have borne. They do not bear that portion of the corporation income tax which is shifted.

As in the case of liberalized depreciation, a deduction for dividends paid would be tantamount to tax reduction on a selective basis. Together with liberalized depreciation and reduced taxes, the combined tax reduction would constitute a substantial improvement in the investment climate for business and should contribute appreciably to a higher rate of growth.

## Individual Income Tax Rates

The individual income tax rates are to a certain extent inequitable and prejudicial to growth, and they fail to contribute adequately to our pursuit of an ever higher degree of economic stability. More specifically, the top rates, which reach to 91 per cent, are both arbitrary and prejudicial to economic incentives; the three-schedule system, which differentiates on the basis of marital status, discriminates unnecessarily against single persons and heads of households; and progression, which is overdone at the top of the income scale, is underdone at the bottom, being left exclusively to the effect of personal exemptions. The starting rate of 20 per cent is the only rate that affects about three-quarters of the taxpayers.

*Cutting the Rate at the Top* It would cost little revenue to scale the progression at the top to a maximum of, say, 75 per cent. The present rates are a legacy from the war. For administrative reasons, it was not feasible to apply either the excess profits tax or an excess income tax to war-created individual incomes. Also, successive increases in the starting individual income tax rate, made necessary by war finance, had to be compensated, largely for political reasons, by rate increases all along the line. That explains how we got to 91 per cent.

Nobody defends these excessive rates. Fortunately, we do not have, in either party, extremists who are disposed to make a political case for them. Yet we have continued to live with excessive top individual income tax rates for more than fifteen years. The damage inflicted on the economy can easily be exaggerated; if the revenue cost of reducing these rates is relatively small, so, in all probability, is their economic impact. But incentives are delicate matters. We can ill afford to ignore the potential ill effects of these excessive rates on investment and,

[7] The defects of this provision are clearly analyzed in the hearings on the President's 1961 tax recommendations.

though here the effects may be milder, on the development and deployment of the skilled segment of the labor force, particularly the business managers.

*Eliminating Two Rate Schedules* In effect, we have three rate schedules that are applicable according to marital status. Married couples are treated most favorably, single persons least favorably, and heads of households given roughly half the concessions to the blissfully married. Couples filing separate returns are treated as harshly as single persons. For example, the marginal rate is 50 per cent on the dollar in excess of $16,000 of a single person's income, 42 per cent for the head of household, but only 34 per cent for a married couple. Since 1948, in response to the vexing community property laws in nine states, married couples are allowed to aggregate their incomes and deductions and split their returns on a 50-50 basis, with all the benefits that this implies. A single person with substantial income is saved thousands of dollars in tax each year by acquiring a wife, and the married man suffers a tax burden by the loss of his wife. The tax differences are arbitrary, varying with size of income. They were not deliberately planned that way. We now know several better methods of handling the community property tax problems; we might, for example, extend full income-splitting to all single persons and heads of families, thus scrapping two of the present three rate schedules.

*Splitting the First Bracket* Finally, if the first bracket of income were subdivided into at least two parts, the fairness of the tax and its responsiveness to changing economic conditions would be materially improved. The personal exemptions provide substantial progression for the lower incomes even now with the flat starting rate of 20 per cent, the only rate applicable to such a large percentage of aggregate taxable income. But the progression is largely offset by the regressive state and local taxes. Splitting the first bracket would help to obtain a desirable degree of over-all progression for the great majority of taxpayers.

These three improvements in the federal income tax would lose substantial amounts of revenue, unless appropriate adjustments were made in the rates from top to bottom. Conflicting considerations of equity and incentives would need to be resolved. In the past, this conflict has always been resolved by postponing the split of the first bracket. A small step would represent progress even if, for practical reasons, the starting rate could not now be dropped much below the present 20 per cent.

### Individual and Corporate Income Tax Bases

Before getting involved in the problem of rate adjustments required to hold the line on revenues, it is important to explore the possibilities of broadening the tax bases for both the individual and the corporate income tax.

Since over one-quarter of personal income is protected from individual income tax by the allowable personal exemptions of $600 per capita, there is a strong argument against further narrowing the tax base and thereby raising marginal rates, which would adversely affect economic incentives. Particularly vulnerable are all nonbusiness items of deduction that have developed in a planless way, partly on a logrolling basis and partly on a basis of sentimental, rather than economic, considerations. It would be possible to finance much of the federal tax reform—not the tax reform of the individual income tax alone—and still have something left over for rate reduction, if there could be stricter enforcement (to help shrink nonreported income and to increase the scrutiny of nontaxable returns) and if, simultaneously, most of the exclusions, exemptions, and deductions were eliminated.

Since these problems have been fully discussed in the literature, I need only recall a few key issues.

*Percentage depletion for the extractive industries, which allows tax-free recovery to*

*the extent of several times the original cost of the assets.*

Percentage depletion is perhaps the outstanding example of a tax issue which is so highly controversial that little progress can be expected from normal legislative procedures. Elsewhere I have recommended, therefore, that with respect to this and other such issues, the Treasury should try even harder to work out basic agreements with the respective industries, in advance of the debate and testimony before the Congress. Only residual matters or choices between alternative solutions should be left for the Congress to decide upon. Where private and public interests clash, where there is a lack of essential evidence or the capacity and good will to accommodate differences, the customary informal negotiations between taxpayers and Treasury must be supplemented by special studies and reports designed to give the Congress a better chance to deal with the issues in a responsible way.

Since we are prepared to go far in the direction of stepping up depreciation, it would not appear logical to go far in the direction of stepping down depletion. But we must go some distance if the taxpayers in general are to retain their faith in the fairness of the burdensome taxes that a troubled world compels them to bear, and may compel them to bear for decades.

It is an accounting sin to expense a capital item, but it is not necessarily a sin against desirable public policy. Granting the need to nourish incentives but without yielding more than that, let us re-examine the law as it affects exploration and development expenses and integrate the treatment of these expenses with the depletion provisions.

If it is an accounting sin and a sin against public policy to depreciate in excess of cost, why not apply the same standards to depletion? If, as a matter of public policy, the President is prepared to give up the traditional bench marks for depreciation, let us not continue to cry shame when the extractive industries want to insist on continuing percentage depletion in the name of the same policy objectives.

This goes farther than some of us are prepared to go, at least cheerfully. But let us not forget that, in addition to more liberal depreciation, the President also supported discrimination in the interest of efficiency. As I apply it to depletion, this means that the rates of percentage depletion should bear some plausible relationship to the needs for incentives, which vary from product to product. Thus a taxpayer might be allowed to write off 200 per cent of the cost (possibly including exploration and development expenditures) for one product but only 150 per cent for another. Similarly, in response to essential incentives and public policy requirements, existing discriminations between (1) deposits in the United States and deposits abroad, and between (2) alternative forms of organization of American extractive industry operations abroad should be widened or narrowed. The Congress will require more evidence than is now available before it can be expected to accept this conclusion.

*The exclusion of half of long-term capital gains and the favorable alternative capital gains tax rate that differentiates capital gains from other income.*

Here is another highly controversial problem that should be subjected to pre-Congressional treatment. It is more controversial and it affects more taxpayers than percentage depletion. The capital gains provisions have been more persistently assaulted and more frequently revised than most segments of the income tax, but the law is still far from satisfactory.

In general, it is important to move as far away as practicable from the present system of segregating and differentiating capital gains (and losses) from other income, for it is these features of the present provisions that are responsible for inequities and enforcement problems.

In my view, it is entirely possible to move a substantial distance toward stabilizing these provisions so that the income tax would become fairer while contributing more to the growth and stability of the economy.

Capital gains and losses are split into

short- and long-term gains and losses at the six-months dividing line. In the case of both individuals and corporations, 50 per cent of net long-term capital gains may be excluded and subjected to an alternative rate of 50 per cent. Thus the effective rate is 25 per cent. Individuals may elect to include 50 per cent of such gains with other income and subject them to the generally applicable rates. Since the taxation of long-term capital gains may become highly favorable by comparison with the taxes applicable to other income, one would expect that the features which bring this result about—the dividing line between short- and long-term capital gains and losses, the exclusion of half of net long-term capital gains, and the favorable rate applicable thereto—would be well founded in accounting or other principles. But this is not so.

To approximate accrual, it would seem desirable to adopt a multiple-holding period with decreasing percentages of gain taken into account as the holding period lengthens. Thus 100 per cent of the gain could be included if the asset is held one year or less, and the per cent included stepped down by 5 percentage points for each additional year the asset is held, with a limitation of 50 per cent on the exclusion regardless of period held beyond ten years. This would be administratively simpler than allowing the taxpayer to spread back the gain over, say, five years. Moreover, a spread-back might not reflect the changing income status of the taxpayer and certainly would not reflect the changes in the tax rates over the period of accrual.

If the pattern of accrual could be approximated satisfactorily by either of these alternatives, the equity case would vanish, and the case for a special capital gains rate would rest exclusively on the need for investment incentives. Thus, it could be argued that the schedule of capital gains exclusions designed to approximate accrual should be stepped up for incentive reasons, just as the schedule for depreciation should be stepped up to promote investment. If, however, the objective is to provide such incentives, there is no reason why equity considerations should be sacrificed beyond what the circumstances require. The culprit is the arbitrary rate limitation. The incentive job can be done and progression better preserved by adjusting the proposed multiple-holding period schedule of exclusions rather than by coupling an admittedly arbitrary holding-period schedule with a still more arbitrary rate limitation.

Finally, the present restrictions on capital losses are prejudicial to enterprise. In general, capital losses are limited to capital gains, except that capital losses from property used in trade or business are treated as desegregated ordinary losses and individuals are permitted to offset up to $1,000 of capital losses against ordinary income. Both corporations and individuals are allowed a five-year carry-over of net capital losses. In the case of corporations, the distinctions between capital gains and losses and ordinary gains and losses seem to be entirely without foundation and should be abolished. With this would disappear the segregation of capital losses.

In the case of individuals, it is not possible, for practical reasons, to make such a sweeping recommendation. We cannot remove the barrier of segregation because the huge volume of loss-laden assets (many now of historic interest only and without opera-

tional significance) could embarrass the government's fiscal policies. We should, however, raise the capital loss offset against ordinary income of individuals to at least $10,000 instead of the $1,000 a year, retaining the present five-year carry-over of capital losses. This would improve the climate for risk assumption and, simultaneously, increase the responsiveness of income tax yields during periods of recession.

*Taxation of foreign income, which does not permit tax deferral for foreign branches.*

Foreign branches are now taxed as if they were departments of domestic corporations; the income or loss from a foreign source is currently brought to account and mingled with income or loss from U. S. sources. In the case of foreign subsidiaries, however, even if wholly owned by U. S. citizens, residents, or corporations, the income or loss is not currently brought to account for U. S. tax purposes. The tax on income is deferred until received by the taxpayer, and the net loss accumulated over the years, if any, may be brought to account only upon liquidation of the foreign corporation. The postponement of income tax is tantamount to a substantial rate reduction, the reduction depending upon the period of postponement and the rate of interest used in computing the value of the deferral.

Four years ago, I urged that U. S. tax treatment of foreign income be equalized for alternative forms of business abroad. I recommended: (1) "that U. S. corporations be permitted to elect subsidiary treatment for their foreign branches, which would result in deferral of tax on income and denial of current offset of losses, as is now done for the profits of foreign subsidiaries," and (2) "that U. S. corporations be permitted to elect whether or not to consolidate their foreign subsidiaries with the domestic subsidiaries and the parent corporations, which would result in the current taxation of profits and the current offset of losses." These changes would have gone far to stimulate investment abroad.

Two years ago, I re-examined the issues involved in deferral and concluded that "in retrospect it would have been better to have restricted deferral to corporations operating in less developed countries."[8] Deferral, even if not so limited, will continue—for a substantial period pending the closing of the gap between U. S. and foreign rates—to deploy investment abroad in the direction of the less developed countries. With important exceptions (India, Pakistan, Ceylon, Burma, and a few others), the less developed countries impose much lower rates than we do. I suggested that, in extending deferral to branches, it would be desirable to limit this to the less developed countries if simultaneously it were feasible to limit deferral for foreign subsidiaries in the same way. I felt that "if it can be done, without great damage to our basic objective of increasing the flow of U. S. investment into the less developed areas, it should be done." I expressed some concern about the shock to expectations but felt that "after a relatively short transition period, the results should be favorable."

Since then, balance of payments considerations have served to strengthen the case for eliminating deferral for U. S. investment in developed countries. I endorse the President's 1961 recommendations on this point, but it still seems to me desirable to extend deferral to branches operating in the less developed countries.

## Estate and Gift Taxes

To ease the political burden of sponsoring a reduction in the tax on upper individual income and in the income from property generally through the proposed rate reduction and dividend deduction under the corporation income tax, it would help if the estate and gift taxes were increased and modernized. The present discrimination between alternative time patterns of property disposition should be eliminated.

[8] *National Tax Association Proceedings of the 52nd Conference* (October, 1959), p. 327.

The simplest and most preferable way to accomplish this result is to bring *inter vivos* transfers of property and transfers at death under the capital gains tax provisions of the income tax.[9] Some lawyers will scream that this would violate the federal Constitution. If it is constitutional to tax gifts and bequests, it is difficult to see why a mere change in the shape of the implied rate schedules should result in a violation of the Constitution.[10]

## Federal Sales Taxes

The federal government levies excises on the sale of selected items of tangible personal property and services; it leaves the general sales tax to the states and local governments. About 60 per cent of the revenue from the federal excises is derived from the taxes on gasoline and other motor fuels (tied to highway finance) and from taxes on liquor and tobacco (tied to tradition and a vague notion that if these allegedly harmful consumption items are not taxed, then something more essential must be taxed). What is left is a motley array of items taxed at rates that are difficult to defend. Such rates either lack uniformity, or are only spuriously uniform, some being based on manufacturers' and others on retailers' sales prices. In the aggregate, $4 to $5 billion in revenue is involved. Since market structures and markups vary from item to item, the only sensible uniform rate sales tax is a retail sales tax. This would invade the field that is now so well cultivated by the state and local governments.

Instead of competing with these levels of government, the federal government should repeal all or most of its miscellaneous excise taxes, and retain only the core of the system, that is, the taxes on motor fuels, liquor, and tobacco. The federal government does not need a general sales tax now and will need one in the future only if the international situation deteriorates further. For peacetime fiscal purposes, the federal government's tax system now possesses adequate flexibility and maneuverability. It has the enormous revenue potentialities of the first bracket rate of the individual income tax and the even more broadly based payroll tax that need not stay forever wedded to financing of benefits under the social security and unemployment compensation programs. A general federal retail sales tax would give the federal government a third fiscal instrument, potent both for revenue and regulatory purposes, when it has not yet mastered the art of properly using the tools that it already possesses.

For a decade before 1913—that is, before the adoption of the Sixteenth Amendment—the compatibility of the federal income tax with a free enterprise system was seriously debated. In the light of the record over the succeeding five decades, I doubt that there is widespread support for attempts to supplant a major part of the income tax with a general sales tax, proportional or regressive. The degree of regressivity of a general federal sales tax would depend upon the structure of the tax base, principally upon whether food and other necessities were excluded.

## Administration and Enforcement

The President's 1961 recommendations have much merit, and, in particular, they have the courage to tackle the always unpopular task of better fitting the tax law to the backs of taxpayers.

For several years now, millions of dollars of revenue have been lost from underreporting of dividends and interest. For several years before 1961, the Treasury, surmounting initial technical difficulties, had

[9] For example, pending the adoption of a general averaging system, the value of gifts and inheritances could be included to the same extent as other capital gains held, say, five years.

[10] The suggestion to include transfers under the gift and estate taxes in the income tax base would not solve all the vexing problems of distinguishing between completed and incompleted transfers. This set of problems would still need to be left to distinguished scholars in the law, best exemplified perhaps by those that participated in the work of the Treasury's 1947 Advisory Committee, *Federal Estate and Gift Taxes,* a proposal for integration and for correlation with the income tax.

urged the Congress to pass an administratively feasible plan to withhold on dividends and interest. This was repeated in 1961.

For years it has been well known that a minority of scheming taxpayers were violating the spirit, if not the letter, of the tax law by padding expense accounts. The 1961 recommendations called attention to this item.

For years we have known that something is wrong with the handling of the deductions for advertising expense. Satisfactory solutions to problems in this area are hard to come by and will require an assist from public-spirited lawyers and accountants. The line to be drawn must be reasonable in concept and enforceable in practice. The conceptual problems are not easy; for example, should a department store be allowed to deduct the cost of a full-page advertisement, bearing only the portrait of Abraham Lincoln and the inscription "Lincoln was a great president!"? If the answer is "Yes" because this brings good will and business, then try substituting pictures and names until more controversial territory is reached. Should I as general taxpayer contribute to the financing of such "business" costs? Are they indeed legitimate business costs or an attempt to give wide circulation to private prejudice at public expense?

Soft enforcement and administration are appropriate for soft concepts and discriminatory taxes. If we want tough and equitable tax administration, we had better get on with the job of tax reform, starting with the federal system.



BROAD acres are a patent of nobility; and no man but feels more of a man in the world if he have a bit of ground that he can call his own. However small it is on the surface, it is four thousand miles deep; and that is a very handsome property.

—*Charles Dudley Warner*
MY SUMMER IN A GARDEN (1870)

Stanley H. Ruttenberg

# OVERHAUL NEEDED IN OVERSEAS BUSINESS INVESTMENTS



The controversy concerning U.S. private investment overseas centers on some crucial national questions: Can this country and its businessmen adapt public and private policies quickly enough to meet rapidly changing world conditions? Will private business decisions be effective instruments for building a healthy future here and abroad?

Answers to these questions depend on America's ability to appraise accurately the rapid changes already under way around the world. They depend on the American businessman's ability to act on the undeniable fact that private overseas investment has enormous political and economic significance.

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Even a cursory glance at economic changes and investment patterns shows that a basic shift in the world economic environment has not produced a basic shift in our foreign investment patterns. While the design of the patterns has changed slightly, there has not been a major revamping in style or kind of investment.

## TWO BASIC SHIFTS

### The Shift That Occurred

Since World War II, a variety of forces have swiftly reshaped the problems facing the United States and its business interests abroad. A group of highly industrialized nations has emerged in a rebuilt Europe. War-ravaged industrial countries have recovered their prosperity. A booming, bustling West

Germany, a new type of British economy, and the newly industrialized countries of France and Italy have produced political partners, economic recipients of U. S. investment, and active competitors of ours. Japan, once a defeated enemy country, has become a competitive ally.

Regional integration in Europe, such as the European Common Market established in 1957, has proceeded toward its goal of coordination among European countries. These developments in Europe (to be followed by similar developments in Latin America and perhaps in other places) create problems for American business—the need to compete and the need to improve its competitive position to take advantage of new markets. The decision on whether to establish facilities within the new tariff walls to meet internal market demands, the problem of locating in new markets or trying to sell to them from the United States, and the relationship between U.S. tariffs and those of regional blocs are considerations that this country and its businessmen must face.

While the European nations and Japan have far surpassed their former industrial strength, the less developed nations of the world have felt the political force of emerging nationalism and social revolution, without the necessary concomitant of developing economic strength to ensure stability.

In the United States, new technology and increasing efficiency have produced a growth potential that is unmatched by performance. Despite fantastic output, production, and employment, times of prosperity no longer erase high unemployment. Recurring recessions are indications of factors hampering the nation's forward development. Increasing competition around the world presents added difficulties during times of high unemployment and economic recession, and these difficulties remain unsolved even when recovery is under way.

America's quadruple world role—world banker, world investor, world trader, and world aider—is not being performed smoothly enough at home and abroad. Balance of payments difficulties are further evidence that some new measures may be necessary to adapt the U.S. role to changing conditions in the world. In such a revised role, the United States would share some of the aid problems with new revitalized European partners, reassess its position as banker, and start revamping its activities in world trade.



### THE SHIFT THAT DID NOT OCCUR

Despite the emergence of a totally new economic environment by the end of the fifties, American public and private policies have not shown equally marked changes. In fact, even most of the changes suggested by the new administration in its attempts to find ways of meeting new situations have been regarded with suspicion, alarm, or anger. This is not to say that the administration's proposals are necessarily the best possible ones for each situation, but it is interesting to note that, for example, in the case of the tax proposals regarding foreign investment, the expressly stated purpose of the legislation proposed was denied by many business spokesmen who opposed it.

Specifically, the Secretary of the Treasury, Douglas Dillon, a businessman of high repute, stated that the administration's proposed changes in the tax law were not seeking to "penalize private investment abroad," but to avoid "artificial encouragement to investment in other advanced countries." The deferral of taxation until income is returned from abroad and the devices for funnelling income of foreign subsidiaries to "tax haven" countries are the objects against which the legislation was intended. The objective is merely to remove the tax factor as an incentive for investment in industrialized countries.

Such removal is not designed to affect other reasons American business has for locating abroad. In Secretary Dillon's words, "There is absolutely no thought of penalizing private investment abroad which rests upon genuine production or market advantage." Yet the suggested legislation has met such strong opposition, with no alternative proposals offered for accomplishing similar objectives, that one can only conclude that American business believes that the patterns of investment abroad are at the present time

appropriate for the long-range best interests of U.S. business, and for the nation as a whole.

Yet these patterns are basically the same as in the past, despite the emergence of a vastly different world economic scene. Available data show that the value of U.S. direct investment overseas has almost tripled since 1950. It has risen more rapidly since 1950, and particularly since 1955, than at any other time in our history; but its pattern has not changed significantly. The shifts have been from the advanced nation of Canada to the advanced nations of Europe and Japan. Prospects for next year, as reported by the McGraw-Hill Economics Department survey of August, 1961, show a slight decrease in amount but no major change in direction between advanced countries and less developed countries. Investment in the less developed nations continues to be largely for nonmanufacturing purposes—in petroleum and mining, which extract but do not develop the resources of those nations.

## DISTORTIONS HERE AND ABROAD

This movement of private capital for manufacturing production abroad presents two problems of utmost importance to this nation. Distortions have occurred in our economy from unfair competition and from resultant joblessness. Distortions in U.S. and world economic development from the lack of appropriate investment in the emerging nations have also developed. Both kinds of distortions should be corrected.

It must be made clear in discussing these problems that there is no economic justification for assuming that the investment of capital even in a highly industrialized Western European nation necessarily produces any distortion in our economy. In 1960, the Department of Commerce listed the following factors as the major reasons given by manufacturing firms for their decisions to make such investments (not one of them in itself should create any distortion here):

"Cost advantages in producing closer to markets, especially when materials or components and trained labor are available; consumer preferences for locally produced goods; gains in expert knowledge of market conditions and access to patents or licenses to produce specialized items through joint operations with local entrepreneurs; mounting financial strength of U.S. companies, facilitating the purchase of existing foreign concerns, often as a relatively quick method of countering developing competition; pressures from tariffs, exchange controls quotas and patent laws that give major advantages to locally produced goods."[1]

Assuming the continued development of a strong demand in the markets of Western Europe and assuming the emergence of stronger markets in other areas of the world, such investment could, in effect, strengthen the American economy both in the short and long run.

But certain developments in the direction of and in the reasons for the investment can produce obvious distortions in our economy, often at the worst possible time for the well-being of business at home, that is, during a recession. There is no doubt that some U.S. jobs have been "exported" and, while the effect is subject to controversy, there is evidence that our exports have been affected by the outflow of capital for investment in manufacturing in Western Europe. The United States and its businessmen cannot afford either effect.

### Exporting Jobs

The definition of "exporting" a job, as intended here, refers to the American company's foreign production of goods designed for sale in the American market. On the basis of some evidence gathered by a few AFL-CIO affiliated unions, it is clear that exporting of jobs has occurred in such industries as women's apparel, men's clothing, the electrical, and the typewriter industries. For example, in September, 1960 a typewriter manufacturer reported he would move all production of nonelectric office and portable typewriters to Europe. The lowest-priced portable is exported to this country.

Recent data as to the extent of foreign manufacturing production for resale in the

[1]U.S. Department of Commerce, *U.S. Business Investments in Foreign Countries* (Washington: U.S. Gov't Printing Office, 1960), p. 19.

United States are not available. A 1957 Commerce Department survey of sales by American overseas plants showed that over $1 billion of total sales by such firms were of manufactures and semimanufactures shipped back to the United States. There is no doubt that the trend since then has been toward even higher sales of this kind.

The labor movement has strongly opposed such exporting of jobs and has suggested or supported tax policies designed to stem the flow of capital for that purpose. One proposal recommends the immediate application of the full corporate tax on profits earned by U.S. firms from the sale of products shipped back from their overseas operations. Specifically, this proposal would require that the full tax should be paid when the overseas corporation receives more than 10 per cent of its total gross revenue from the sale of its foreign-made products on the American market. This would apply to products from both industrial and nonindustrial countries.

Such a measure, the AFL-CIO believes, would help stop the destructive exporting of jobs, but it would also have a broader result. It would retard what Peter Drucker calls "rank defeatism" on the part of American business by the "completely foolhardy" practice of "building . . . a foreign plant to supply the American manufacturer for the home market." Drucker contends that this kind of foreign production "aggravates the disease by eroding purchasing power at home." He asks U.S. business to use the following criterion: "Does building the plant result, ultimately, in a strengthening of America's competitive position?" If not, "Such a move amounts to strangulation of our nation's economic power and competitive capacity."[2]

American labor, therefore, has decried, not the natural desire of firms to locate in Western Europe to take advantage of growing markets or consumer preferences, but the unwillingness of some firms to recognize that some investments abroad may well produce distortions both at home and abroad.

[2]Peter F. Drucker, "This Competitive World," *Harvard Business Review*, XXXIX (March-April, 1961), 131-35.

### Tax-Induced Distortions

The U.S. labor movement has not suggested legislation, similar to that used by some European countries, that would control export of private capital. It has supported, however, administration-proposed legislation that is designed to curb distortions here and overseas.

For example, the proposal for changing two types of tax provisions in European countries seems not unreasonable to those who recognize that European nations have been rebuilt, that capital is available there, and that the crying need for revitalization has been met. The long-standing tax incentives for investment of private capital overseas in the industrialized world seem obviously unnecessary if the capital is going to be invested there for the purpose of reaching the expanding regional markets and not for the purpose of escaping taxation.

The second proposal—for cutting off tax havens (an evasion of taxation)—seems quite reasonable to those who have witnessed the establishment of foreign subsidiaries for tax purpose at a time when U.S. revenue problems are of world-wide import. For example, *Fortune* has said,

> "Switzerland, of course, has become the principal headquarters for sales, marketing, and administrative operations of U.S. plants all over Europe. Offices of an estimated 500 U. S. subsidiaries are now located in the country, and of these some 200 are in Geneva.
>
> ". . . Caterpillar Tractor's Swiss subsidiary, one of the most recent arrivals, employs Americans and Swiss to supervise all sales in Asia, Africa, and Europe except for Great Britain. . . .
>
> "Taxes—Swiss, American, and otherwise—are one important reason why Geneva is so popular as an international headquarters. Swiss taxes on foreign subsidiaries and holding companies are comparatively modest. . . . Because of these low [Swiss] rates, some international firms are able to reduce their total tax loan by piping sales revenues of non-Swiss companies directly to Switzerland. . . .
>
> "If the Kennedy Administration has its way, this tax advantage may soon be removed. At present, U.S. corporations can funnel all income from foreign subsidiaries into Swiss

headquarters and then plow it back into other foreign operations or use it to initiate new foreign investments—all without payment of the 52 per cent U.S. corporation tax. Caterpillar Overseas, for example, was founded last fall with initial capital of $23,300,000, all brought directly from Caterpillar Overseas in Venezuela."[3]

*Fortune* claims that the removal of the tax advantage would probably not "inhibit the growth of the American community in Geneva."

*Business Week* tells the story of Harley-Davidson, the first American motorcycle manufacturer to invest in production facilities abroad. The production is in Italy. However, "Harley-Davidson, S.A., was set up as a Swiss subsidiary to administer H-D's interest in the Italian company and take on whatever other tasks of an international nature that may come up as the Milwaukee company feels its way into the overseas expansion."[4]

Few would contend that the attraction of U.S. subsidiaries to Switzerland is not affected by the tax loophole now in the law, a loophole that even *Fortune* believes is unnecessary to attract business there.

This draining off of sales revenue from nations around the world could produce a much more serious distortion than has already occurred. As long as tax havens exist, the problem of using funds wisely around the world will be affected by a gimmick in the law.

### World Economic Distortion

It seems then that one can generalize that manufacturing investments have gone mostly to the highly developed countries, not the less developed nations. True, the pace has increased everywhere, but it is in the less developed nations that the greatest dearth of capital and the greatest threat to America's future world business prospects exist. It should be clear to almost any observer that our hope for our political and economic future lies in the underindustrialized sectors of the world. Yet it is equally clear that the less developed nations, who get more manufacturing investment now, still receive almost nothing in comparison with their potential.

For example, the *Survey of Current Business* reports that American direct manufacturing investments in Africa, Asia, Oceania, and Latin America (included, of course, are the more industrialized nations such as Japan, as well as areas of initial development such as some South American countries) amounted to $2.5 billion out of the $11.2 billion total of such overseas investments.[5] In 1950, slightly over $1.0 billion went to those areas out of a total of $3.8 billion overseas investment. The pattern of investment thus stays roughly the same.

This pattern exists despite the fact that the *Survey* reports ". . . manufacturing ventures by U.S. companies in Latin America were expanded at a record rate in 1960, and appear likely to continue at a high rate in 1961"—not only because of expanding markets, but because of new rules about local manufacturing. Total value of U.S. direct investment in Africa in 1960 (in manufacturing) amounted to $118 million, and in Asia (Middle East and Far East) some $286 million, of which $182 million was in Japan and the Philippines.

These are high-risk areas, and American business seems to be helping to make them riskier. We have been exporting capital to the less developed countries for years, but mainly for extractive industries. We have extracted—not developed—these countries' resources. The value of direct investment in mining and smelting in Latin America, Africa, Asia, and Oceania amounted to about half the value of total United States overseas investment for these purposes, some $1.5 billion in 1960 out of $3.0 billion. For the same areas, the value of direct investment in petroleum in 1960 amounted to some $5.3 billion out of the total. Thus total

[3]"The Business Globe," *Fortune*, LXIII (June, 1961), 95.

[4]"U.S. Motorcycle Maker Guns for Foreign Sales," *Business Week* (August 12, 1961), pp. 74-76.

[5]Samuel Pizer and Frederick Cutler, "United States Assets and Investments Abroad," *Survey of Current Business*, XLI (August, 1961), 21.

direct investment in mining and petroleum in these four areas amounted to roughly $7.0 billion, while direct investment in manufacturing was only $2.5 billion.

Petroleum investments seem to be slacking off somewhat, but the big flow of manufacturing investment capital will continue to be to the European Common Market area. The recent McGraw-Hill survey shows that the Common Market countries will attract an estimated total of $739 million in U.S. manufacturing and petroleum investment in 1962, far more than all other areas. Petroleum and manufacturing investment together in the Middle East, Africa, and Asia will amount to $681 billion in 1962, according to the McGraw-Hill report. There are no grounds for believing that, even with the cutbacks of petroleum investment, this area will receive a large proportion of the investment in manufacturing.



### ANTI-DISTORTION EFFORT

Let me re-emphasize that no effort is now being taken to *control* the direction of capital investment or insist that certain investments take place. Nor can one in fairness support the *First National City Bank Monthly Letter* complaint last June that there is an assumption that "private capital investment is at least a bad boy, if not the bad boy in the U.S. balance of payments problem." Private capital investment overseas is praised by almost every spokesman for this nation, whether from business, government, or labor. The real question, however, is whether this nation will continue to *encourage* capital to go where it will travel anyway—by business's own admission—and where indigenous capital is plentiful now, or whether the United States will continue tax inducements only for the less developed nations of the world where capital is desperately needed.

## WHAT IS NEEDED

Certainly from the standpoint of the American businessman or any economic viewpoint, this current failure to send more manufacturing capital to the less developed nations is entirely justified and unavoidable in many areas. Surely American self-interest does not call for trying to set up a nylon plant in a desert area with no power facilities. The infrastructure of many nations has not even begun to be developed, and no signs of such development are readily apparent to the businessman in this country.

Nonetheless, the fact that America's productive capacity has become swollen while Western Europe's is also expanding at a rapid pace means that some way must be found to prevent the rapidly developing world economic distortions from resulting in catastrophe. Obviously, investment in Western Europe will not ensure this country's retention of the European market. Obviously, the industrialized, revitalized nations of Western Europe are competing with the United States businessman in every nation in the world. Equally obviously, the United States cannot buy up all the plants abroad and compete with itself. The answer is not to be found in continuing the same patterns of investment as in the past, as if the world were not changing; the answer lies in making every effort to ensure the rapid development of other markets around the world through further growth and development of those vast areas now largely untouched or where industrial development has been lopsided.

This lopsided development of some areas is as dangerous to America and its businessmen as no development at all because the political winds are changing. Too much speculation has already gone into what might have happened instead of what actually happened in Cuba. It is clear, however, that many observers believe that different approaches to business investment in Cuba could have obviated many U.S. business and political losses there, despite the emergence of a revolutionary tide. For whether or not the American likes the twentieth century's revolutionary tide, this seems to be an era of emerging nationalism and social revolution. If atomic catastrophe is averted, America and its businessmen still face the potential catastrophe of losing even what investments now exist in nations where

revolutions are possible. However abhorrent the communist activities may be to us, it should not escape our attention that they have proved less abhorrent to the Cuban cane cutter who does not even understand that they are communist activities. At a time when millions of people are subject to the onslaught of a philosophy that denies the value of what America believes to be right, American business cannot afford to behave as if social revolutions, nationalistic developments, and communist insurgence do not exist. From a purely business point of view, American industry should recognize that some of our ways must either bend or break in the face of emerging nationalism and social change.

This requires a world consciousness to help expand world markets. It does not require a sacrifice of the principle behind either free enterprise or private investment abroad. It does require recognition that changing world conditions mean that developments abroad cannot be expected to proceed with the patterns followed by the industrialization of either this nation or the nations of Western Europe. The time span is shorter; the methodology of industrialization is more pervasive and sweeping; and the starting point now involves different economic relationships. Technological change, new methods, and new social and economic progress make this a different world both at home and abroad.

According to President Kennedy's remarks concerning these problems, it is clear that the administration believes that what he calls the "rising expectations" of many nations represent changes to come, changes that need America's cooperation if our political and economic opportunities are not to be weakened. It is equally clear that only through efforts by business and government can American business continue to have rising expectations in many parts of the world.

To support these expectations, it is obvious that private investment in less developed or underdeveloped countries requires a structure on which to build; in many areas, the infrastructure of telecommunications, power, transportation, and health and education systems is totally lacking. Public activity in some countries is essential to create the base on which industrialization can build.

### Business Reactions

It is, of course, a matter of opinion whether we can successfully extract the resources of the underdeveloped nations, fail to develop the structure to support industrialization, or refuse to participate in creating infrastructures not entirely private in nature. The current administration evidently believes that the United States has a political and economic responsibility to help develop viable economies in many nations, not merely to superimpose our system or extract their resources. Yet the ringing rhetoric used to describe these programs is reportedly disturbing to many parts of the American business community.

*Business Week* has stated,

"To a considerable degree, the revolution of rising expectations is a revolt against capitalism, or at least against the way it seems to operate in the underdeveloped nations.

" 'It took 15 years and many billions of U. S. government dollars to rebuild the capitalist world on the Bretton Woods pattern,' says one critic. 'The Administration will bring the system crashing down, if it isn't careful.' ". . . Most executives think that, in attempting to finance both economic development and social revolution in the underdeveloped nations, the U.S. will be pursuing contradictory objectives."[6]

This attitude, it seems to me, represents an unwillingness to bend rather than break in our efforts. Developments around the world, rather than the administration, seem to be threatening to "bring the system crashing down." Those of us who want the system to go on are compelled to evaluate our position in terms of fifteen years after the Bretton Woods agreement, not in terms of the mid-forties.

Certainly some business executives have recognized the change in time, scope, and

[6]"Keeping Out the Reds by Revolution," *Business Week* (July 15, 1961), p. 57.

prospects for the investment position abroad. The CED has endorsed the Alliance for Progress, for example, and Secretary of the Treasury Dillon has proved an able statesmanlike representative of the current administration position. Recently, Secretary Dillon led the United States delegation to the inter-American meeting at Punta del Este where the Alliance for Progress was discussed.

### THE ALLIANCE FOR PROGRESS

The Alliance for Progress deliberations point up what seems fundamental to some adverse business reactions concerning current policy abroad. The "contradictory objectives" some businessmen are reported to fear are these: "Social reform involves a redistribution of income and tends to increase consumption and expenditures at the cost of savings and investment on which growth depends."



Latin American nations demonstrate the fallacy of this view. Most of the U.S. businessmen at the Punta del Este meeting recognized what was clear to the economists present: Many Latin American nations are not underdeveloped but less or lopsidedly developed. Investments have poured into them; recent amounts totaled some \$9 billion of private and \$3 billion of public funds. However, not only the resources but also the capital is extracted from these nations, and the income from the investment is immediately drained off and exported. The capitalist system does not permit a few landowners and businessmen to take the profits of U.S. business and send it to Switzerland while most of the people at home are underfed, living in hovels, disease-ridden, illiterate, and poor. Surely the capitalist system does not require that this situation exist in Latin America. There is, therefore, no inconsistency in predicating an economic aid program in Latin America on the Latin American countries' own internal social and economic reform. The simple fact is that the savings and investment on which growth depends, if one accepts that thesis, are currently leaving Latin America. Income distribution, tax policy, and other reform could keep some of the essentials for growth there.

I do not believe that the average American businessman wants the view of capitalism and the capitalist system to appear as it does in Latin America. I personally do not think gross distortions in income distribution, denial of social decency, and inadequacy of education are representative of the capitalist system. The choice, then, seems to be whether or not to proceed in the actually less developed lands, where this lopsided and gross distortion of a capitalist system has not developed, in a way that will produce more Latin Americas around the world—with, of course, the threat to all investment in such countries—or whether there is a possibility of adjusting programs to a more realistic or representative view of the capitalist system.

THE FUTURE, therefore, depends largely on what public and private policies this nation and its businessmen adopt. The appropriate emphasis, it seems to me, should be on goals that would improve this country's economy and world standing, and would recognize differing national developments so that a sound base for more private investment overseas can be established.

Our tax policy, to the extent that it is at all effective, can note the revitalization of Western Europe and Japan, and avoid both inducement and discouragement of investment in these countries through tax provisions. At the same time, the tax policy can retain inducements for those underdeveloped and less developed areas where new markets must emerge, and where viable economies can affect our economic stability, personal freedom, and world standing.

Foreign aid and private participation in world lending programs, as well as private capital investment, should be designed to promote the kind of economic base where private investment in manufacturing can flourish, and where markets for products can grow. This depends, however, on recognition that different nations may need far more public activity than has been utilized in the United States to accomplish the goals appropriate for those nations.

LEON H. KEYSERLING

# GROWTH ECONOMICS | The Crucial Issues



The recent controversy (which may not be over) between Arthur F. Burns, Chairman of the Council of Economic Advisers during President Eisenhower's first term, and President Kennedy's economic advisers seems to me of much deeper significance than may easily be apparent.

From the strictly economic viewpoint, the deeper significance is this: in the logic and pertinence of their position, it seems to me that the current advisers overwhelm Burns, but they are still in the foothills of the mountain peaks to which American economic thought and action must climb if it is to deal effectively with the domestic needs and international perils that John F. Kennedy so admirably stated in his campaign for the presidency. That the advisers are still in the foothills is not entirely their fault; they are not operating independently of the restraints imposed by their official position.

From the viewpoint of the "political" factors that, in our democracy, properly interpenetrate with purely economic factors in the development of national economic policies, the recent controversy is not merely a slugging match between the "ins" and the "outs." To be sure, Burns is assaulting the foundations of the Kennedy administration's economic policies from the distant and lofty

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objectivity of a publication of the Morgan Guaranty Trust Company, and this assault has been reflected in language as well as in action by a Republican minority of the Congressional Joint Economic Committee.[1] But, far more significant, as a "public representative" on President Kennedy's very important Labor-Management Advisory Committee, Burns is in an unusually strategic position to lean his weight against the kind of economic policies regarding economic growth and other matters that the President presumably would like to see emerge from this committee's current efforts. And I have noted, as a consultant to this committee, that Burns is indeed competent to put forward his own views forcefully.

I say none of this in criticism of Burns' personal conduct. His acceptance of appointment to the Labor-Management Committee did not imply agreement with the administration's economic views nor relinquishment of his right to contest them publicly through every channel open to him. The point is that the President did place upon this committee, to which he attaches such central significance, a chief architect of the Eisenhower economic policies against which he had campaigned so unequivocally in 1960. The President, however, did not see fit to place upon the same committee even one of the many available persons (concerned predominantly, like Burns, with over-all economic problems and policies) who over the years have worked and fought for the types of policies that built so much permanent strength, resilience, and justice into the American economy during twenty years of Democratic administrations—and thus contributed so much to the election of a new Democratic president in 1960. These curious acts of presidential commission and omission shed much light upon the "political" strategy of the Kennedy administration, which in turn has immense bearing upon the economic policies thus far enunciated by the President and his Council of Economic Advisers.

[1]See "Minority Views," *Joint Economic Report*, Joint Economic Committee (Washington: U.S. Gov't Printing Office, May 2, 1961), pp. 59-77.

**BURNS' POSITION**

Let us turn now to the controversy between Burns and the current economic advisers. The advisers on March 6, 1961, through personal testimony before the Congressional Joint Economic Committee in open hearings, presented what is perhaps the most systematic and comprehensive exposition to date of the administration's economic policy.[2] Burns launched his frontal assault upon this testimony in a speech delivered on April 21.[3] The economic advisers offered a formal rebuttal in mid-June;[4] and Burns' prepared surrebuttal appeared in August.[5]

My analysis will be simpler if I begin, not with the economic advisers' initial testimony, but with Burns' speech of April 21. In this speech, he attributes to the economic advisers the "theoretical" viewpoint that, aside from the problem of the 1960-61 recession, there has been a "persistent slack in production and employment, a slow-down in our rate of growth, a growing gap between what we can produce and what we do produce." This leads Burns to assign to the advisers the view that "in short, America faces a problem of secular stagnation," although he magnanimously concedes that they are more optimistic than he says Alvin Hansen was in the 1930's, not to speak of the dark views of Engels and Veblen in earlier times.

Aside from the charge of "secular stagnation," which seems designed in this instance

[2]Personal testimony of the Council of Economic Advisers on March 6, 1961, at Hearings of the Joint Economic Committee on the Jan. 19, 1961, Economic Report of the President (Washington: U.S. Gov't Printing Office, February-April, 1961), pp. 290, 574.

[3]Arthur F. Burns, "The New Stagnation Theory and Our Current Economic Policies," speech given at the Tenth Annual Conference of Business Economists, University of Chicago. Published in the *Congressional Record* (April 27, 1961), Appendix pp. 2885-87; and *The Morgan Guaranty Survey* (May, 1961).

[4]Council of Economic Advisers, "The Council's View," *Congressional Record* (June 15, 1961), pp. 9833-36; published also in *The Morgan Guaranty Survey* (August, 1961), pp. 1-6.

[5]Arthur F. Burns, "A Second Look at the Council's Economic Theory," *The Morgan Guaranty Survey* (August, 1961), pp. 6-15.

to cast a slur rather than to clarify the issues and which is effectively refuted by the economic advisers, I think that Burns is essentially correct in his description of what the economic advisers have said. Burns then proceeds to challenge these views with what he calls "empirical evidence."

### Is Mathematics Economics?

First, he says that the council has attempted to reinforce its characterization of the economy by pointing out that, if one looks at the three periods of expansion 1949-53, 1954-57, and 1958-60, one finds that the periods of expansion become progressively shorter. Similarly, Burns takes note of the advisers' reference to the fact that, if one looks at the peaks of the upturns in 1953, 1957, and 1960, each succeeding peak showed a higher level of unemployment than the previous one. His answer to this is that the period 1949-53 and the 1953 peak should not be counted because these reflected the Korean conflict; thus Burns concludes that the economic advisers have really offered only one comparison, which he argues is not enough to really prove anything.

There are some fatal errors, I believe, in Burns' position on this score. If the years 1949-53 had been marked in general by hyperactivity (that is, an excessive strain upon our productive resources), it might well be argued that the strong upward trend of the economy during this period as a whole should be ignored in evaluating our economic performance since the end of the Korean hostilities in early 1953. But the fact is that even during the Korean conflict period 1950-53, our productive resources were not excessively strained, and hours of work actually declined. Severe price inflation during this period was not due to excessive over-all demand upon our productive resources, but rather to speculative excesses. Moreover, during approximately the second half of this period at least, there was reasonable price stability (due more to the balance of supply-demand economic forces than to the existence of direct control).

It may well be true that the high economic growth rate and reasonably high average level of employment and production during the somewhat longer period 1947-53 were sustained first by the unusual backlogs created during World War II, and then by forces generated by the Korean conflict. But since these developments did not put excessive pressures upon the economy in general, substantially lower average levels of performance would have meant far too much unemployment and other waste even if there had been no war-created factors. Moreover, during the period 1947-53, the ratio of defense outlays to total national production averaged lower than since 1953. It follows that the period 1947-53 (or 1949-53) *is* a valid measurement of the growth rate and resource utilization we should have achieved since 1953, albeit by different means and forces from those that obtained in 1947-53. This is doubly true because, *if we assume that there had been the pull of reasonably full resource use* during 1953-60 or 1955-60, there is no reason to assume that the combined growth rate in the labor force and in productivity during these periods would have averaged lower than during 1947-53. Analysis indicates the reverse. Certainly, "peacetime" is no justification for the interruption of our economic performance by frequent recessions.

Thus, Burns' attempted rationalization of the seriously deteriorating performance since 1953 or since mid-1955, with all its costs at home and dangers overseas, is an evasion of our paramount economic problem rather than a substantial economic argument. When Burns took over as Chairman of the Council of Economic Advisers in January, 1953, the loud promise of the administration he served was to sustain reasonably full prosperity without war and without inflation, and not to acquiesce in gross departures from such prosperity because we were not in a shooting war.

In reality, Burns is merely making an economic historian's comment on how the economy might have been expected to behave after 1953 if nothing much were done to help it behave better. This begs the whole ques-

tion of policy raised by the economic advisers, and it begs the whole question of nation-wide responsibility and national purpose.

## Gap or No Gap?

Second, Burns attacks the finding by the economic advisers that the American economy suffered a $32 billion gap in 1960, representing the difference between actual GNP and a calculated desirable level of GNP. The advisers arrive at this gap by starting with the middle of 1955 (when the 4.0 per cent level of unemployment was consistent with what the advisers use as an acceptable level for this purpose) and projecting through 1960 a GNP growth rate of 3.5 per cent per year (which they estimate would have been sufficient, in view of their estimate of productivity and labor force trends, to have held unemployment to the 4.0 per cent level). Burns, in deprecating this whole approach, points out that if a 3.5 per cent annual growth rate were projected from mid-1947 instead of mid-1955 (unemployment also stood at about 4.0 per cent in mid-1947), the result would be a GNP figure in 1960 about $2 billion *below* the actual level in 1960.

I find it hard to believe that Burns will not discover on further reflection that this mathematical demonstration of his is mere obfuscation with respect to the real issues under discussion. For it merely shows that the actual annual growth rate from mid-1947 through 1960 averaged a tiny fraction above 3.5 per cent (4.8 per cent during 1947-53, 2.5 per cent during 1953-60, and even lower from mid-1955 through 1960). Consequently, a 3.5 per cent projection from a mid-1947 base results in a slightly "excessive" GNP in 1960, while a 3.5 per cent projection from mid-1955 results in a very large GNP gap in 1960. But this discrepancy merely reflects the appallingly low growth rate since mid-1955 in contrast with earlier years—the very point the economic advisers make. Indeed, going back to mid-1947 and looking at the years of good performance since then strongly indicate that 3.5 per cent is too small for a useful measurement of the GNP gap in 1960 in terms of a nation committed to sustained maximum employment and production. The fact that it seems clearly to be too small has very important policy significance, as I shall point out later.

What Burns may really be attempting to say, although he does not explicitly do so, is that going back to mid-1955 or even to mid-1947 does not give one a long enough period upon which to formulate a theory of economic growth or policy actions related to this theory, and that, instead, one should go back to, say, 1922 or 1890. While I appreciate the great contributions Burns has made to long-range historical description, he unfortunately has been prone to couple this historical approach with the dangerous suggestion that the more we study the more certain we become that we can never have enough data to remove the uncertainties surrounding any positive and bold choice of new policies.

In any event, while I am willing to go back to any base year or years so long as the accompanying analysis is careful and circumspect, I incline to the view that what has happened in the eight years since 1953 during the cold war is more relevant to the foreseeable future than what happened in earlier times. These later years, in terms of international conditions, the whole framework of domestic economic policies both private and public, and the thrust of the new technology and automation, seem more like the foreseeable future than any period before the termination of the Great Depression around 1940 or the period 1940-53, which was conditioned mainly by World War II, postwar readjustment, and sudden mobilization for the Korean hostilities.

## The Really Relevant Data

Burns is not alone, nor does he lack supporters. A number of economists whose destructive gifts far exceed their constructive talents have indulged in a selective shifting of base dates in their efforts to discredit the emerging economics of economic growth. But the real issues posed by the current economic advisers are plainly these: Do we

now have abundant data to persuade us beyond dispute that our economic performance during the more than eight years of critical world pressures since the end of the Korean conflict has been tremendously unsatisfactory? If the answer here is in the affirmative, must we not be bold and develop new policy approaches?

The data are far too clear for Burns to turn us away from recent and current realities by going back to 1947 or 1847. Regardless of some of the imponderables involved in measuring the 1960 gap quantitatively, developments in the American economy during the more than eight-year period from first quarter, 1953 through third quarter, 1961 have divided roughly into three main categories: (1) recession periods, when the performance of the total economy, measured by total national production in uniform dollars, moved downward in absolute terms, with rising idleness of man power and plant; (2) boom periods, when the total economy moved sharply upward for a time from the recession base, with some reduction of idle resources but not enough to restore maximum employment and production; and (3) stagnation periods, when the total economy continued to move upward, but at a speed too slow to reduce excessive idleness, or at times even to prevent it from rising because the growth in the total economy was not sufficient to absorb the growing labor force and the improved output per man-hour worked (productivity). Each of these stagnation periods, moreover, led into another period of absolute recession, with further increases in idle man power and plant. I have on numerous occasions called this a "roller-coaster" economic performance, and characterized it as representing a "long-term departure from maximum employment and production." Since early 1961, we have been in another upturn or boom period, which thus far seems to me entirely consistent with this roller-coaster pattern and this long-term departure.

Unemployment figures afford an excellent illustration of this point. The true level of unemployment is composed of full-time unemployment plus the full-time equivalent of part-time unemployment. In the boom-recession year 1953, the true level of unemployment was 2.8 million, but in the boom year 1955 it was 4.0 million, and in the boom year 1959 it was 5.0 million, or as high as in the recession year 1954. And in the recession period during first quarter, 1961, the true level of unemployment seasonally adjusted was 6.2 million, or more than a million higher than in the recession year 1954. In the boom year 1959, true unemployment was 7.3 per cent of the civilian labor force, contrasted with 4.3 per cent in the boom-recession year 1953, and 6 per cent in the boom year 1955.

By first quarter, 1961, true unemployment seasonally adjusted was 8.6 per cent of the civilian labor force. The second and third quarters of 1961 were marked by a sharp upturn in total national production and in some other important business indexes. Nonetheless, in October, 1961, full-time unemployment seasonally adjusted was about 6.8 per cent of the civilian labor force (or fully as high as in the first quarter) and the true level of unemployment was about 9.0 per cent, representing thus far no reduction in unemployment from the level reached during the most recent recession. If this is compared with the first nine months or so of the previous boom periods since 1953, the most recent upturn—when judged by its impact upon unemployment—is by far the least satisfactory.

We now find ourselves, in the midst of an upturn or boom that many sober economists think may have run half or more of its course toward its peak, with a true level of unemployment (measured as a portion of the civilian labor force) about 17 per cent higher than in the recession year 1954, and about 50 per cent higher than in the stagnation year 1956 or the stagnation-recession year 1957. And in view of fundamental distortions in the economy, I believe that this latest upturn or boom (in the absence of much more vigorous policies) will carry us nowhere near back to reasonably full resource use, and will be succeeded by stagnation and then recession periods, which will in turn lead to much more idleness of man power

and plant than any we have experienced since the years of the Great Depression.

These unemployment figures can be supplemented by some other indexes. For example, the annual average of plant capacity idle during the period 1954-60 as a whole was about 19.0 per cent for iron and steel; about 23.0 per cent for nonelectrical machinery; about 13.5 per cent for autos, trucks, and parts; about 26.0 per cent for other transportation equipment; above 18.0 per cent for chemicals; almost 18.0 per cent for food and beverages; and almost 12.0 per cent for textiles. In fourth quarter, 1960, about 12.0 per cent of our total industrial production capacity was idle, and at the end of 1960 about 23.0 per cent of our manufacturing capacity was idle. The developments to date in 1961 certainly indicate, despite the much heralded upturn in production, a much larger idle plant capacity now than after nine months of any previous upturn period since 1953.



## Burns' Position Evaluated

In the face of all these data, it would seem to me almost inexplicable that Burns should take so complacent a stand in conflict with the palpably more reasonable appraisal of the current economic advisers, or that he should attempt to evade the central issue by playing around with the choice of base years and the calculation of gaps. However, these tendentious efforts are quite in line with his basic and positive position. He begins to reveal this position when he says in his April 21 speech that there is a "better explanation" of the inadequate upturn during 1958-60 than the "neostagnation" theory that he attributes to the economic advisers. His own explanation is threefold: the excessive shifts in the budget position, from a deficit of $17 billion in first quarter, 1959 to a surplus of $7 billion in second quarter, 1960 (cash budget, annual rates); excessive credit tightness; and the steel strike. He continues:

> "The early onset of recession was due to special factors, to factors of a kind that need not be repeated, rather than to some permanent or growing weakness in our economy . . . there is no chronic slack in the economy. The problem of recovery that we face is not very different from that which we faced in 1949 or in 1954 or in 1958. Full employment is not a remote possibility. On the contrary, it may well be reached some 15 or 18 months from now."

Burns' language at this point seems a curious combination of knocking down straw men, illogic, irrelevance, and unanalytical optimism. In the first place, nobody (certainly not the advisers) has asserted that the early onset of recession was *not* due to special factors (that is, special mistakes in public and private economic policies). Nor have the economic advisers anywhere implied that what they properly call the "growing weakness in our economy" is due to some malevolent omnipresence bent upon creating repeated troubles that cannot be overcome by our own actions.

Secondly, to say that the problem of recovery in early 1960 was "not very different from that which we faced in 1949 or in 1954 or in 1958" is to miss the point; the very fact that we have had this "recovery" problem so frequently is precisely what the advisers are concerned about. More important, we cannot know definitively how long the recovery after 1949 would have lasted if the Korean outbreak had not occurred; the recoveries after 1954 and 1958 were manifestly unsatisfactory and did not reverse the long-term retreat; and the current upturn has not yet carried us out of the woods and may not. It follows that we need new approaches and new solutions, whether or not the problem has changed greatly.

In the third place, Burns offers no satisfactory analysis in support of his cheerful pronouncement that full employment may be reached by the middle or end of 1962. The evidence seems all to the contrary if we adopt only the policies now under contemplation. And even if by accidental good luck we should reach by the end of 1962 the happy state of full employment, which reliance on accidental good luck has not enabled us to reach even once in more than eight years, there is uncomfortably little evidence that this happy state would be reasonably sustained without drastic changes in economic thought and action.

### Some Specifics of Burns' Policies

Taking as its point of departure what seem to me two insupportable propositions—that we have no chronic problem of great magnitude and that we are well on our way to a fine recovery—Burns' discussion of policy concentrates, as one might expect, upon warnings against the dire consequences of new or enlarged federal spending programs, including, apparently, some already under way. In regard to economic restoration, Burns says that there is no need for new spending programs when the economy is advancing. In addition, he says that the expansion of social security, while it would speed recovery, is not a sound way to promote recovery and therefore is undesirable unless such expansion is of long-run value (which he does not say it is). He says that lifting the minimum wage is not "a useful anti-recessionary device, particularly at a time like the present when we are having a serious balance of payments problem," and he certainly does not imply that lifting the minimum wage would be desirable later on.

In short, Burns does not seem to want to do much now or even later on; he does not want to do much about either recovery or long-range growth (even if one accepts more than I do his sharp distinction between the two problems). For he dissents from the proposition of the economic advisers that the consequences of expansionary spending will be "welcomed even if they occur well after the recession has been reversed." He also says that he cannot accept "without some reservations the view that greater Federal investment in education, health, housing, research and resource development is desirable in the interest of accelerating the Nation's long-term economic growth."

All of this lets the cat out of the bag. Burns might well have stated his extremely conventional policy conclusions without burdening his readers with a rather flimsy technical analysis fitted to such policy conclusions but providing no persuasive support for them.

His position becomes even clearer when one examines his surrebuttal statement of August, 1961. Here he reiterates his warnings against the increased trends in spending, especially on international and anti-inflationary grounds. He charges excessive spending in 1958, although in that year we were very far from full resource use. He also offers his own program for economic growth, which is stereotyped and limited: He urges that we stop fighting recession; reduce or hold government spending; establish a broader range of tax concessions to investors; eliminate restrictive practices; improve unemployment compensation; and amend the Employment Act of 1946 to make price stability a prime objective of national economic policy.

### Who Is Guilty of "Caricature"

A further point should be added to these comments on Burns' August, 1961 surrebuttal. Burns says that the position of the economic advisers implies that we have escaped from chronic and persistent economic slack only during wartime. He calls this a "caricature." I do not see how Burns can call a caricature an implied description that conforms very closely to the actual experience of the American economy since 1929, except in wartime or under conditions clearly generated by war. Burns himself is indulging in a complete caricature of clear economic thinking when he attempts to refute the implication of chronic economic slack by citing growth figures in gross national product, indebtedness, real output, employment, and prices. Large absolute upturns in indexes of economic activity have been entirely consistent with chronic slack because these upturns have not kept up in the long run, and have seldom caught up even in the short run, with accumulating increases in the labor force and in productivity.

## THE ADVISERS' REBUTTAL

In their reply to Burns' April 21 speech, President Kennedy's economic advisers agree with Burns' three explanations of the unsatisfactory recovery of 1958-60. They reassert their own view (which they impute

also to Burns) that shortages of aggregate demand rather than structural factors are the main explanation of high unemployment. They agree as to the desirability of certain types of tax concessions to stimulate private investment.

I too believe with the economic advisers (and Burns) that budget and monetary policies were at times much too tight. Indeed, I say they still are. I do not agree with the importance that they attach to the steel strike as a major factor in the inadequate recovery. It may be cogently argued that the recession might have come even earlier if the steel strike, by permitting a working down of inventories, had not temporarily masked some of the fundamental imbalances between productive capacity and ultimate demand in the form of consumer expenditures and public outlays. In this connection, it should be noted that the steel industry resumed a very low level of operations relative to capacity not very long after the steel strike was over. I agree entirely with the aggregative rather than the structural explanation of massive unemployment.

I disagree with the economic advisers in that they attribute the abortive recovery excessively to inadequacies in national economic policies, and do not take sufficient account of many other imbalances and distortions throughout the private economy and the entire economy. This shortfall in the council's analysis has many serious consequences, including what I believe to be erroneous emphasis upon tax concessions to stimulate private investment. As already indicated, the economic advisers seem to me entirely correct in their resentment of Burns' classification of them as "neostagnationists."

## The Growth Rate Issue

The advisers' use of various mathematical exercises to refute Burns' claim that their estimate of the 1960 GNP gap is questionable (because they used mid-1955 rather than mid-1947 as a base) seems to me valid for that purpose. But, in the course of these exercises, the economic advisers point out that to accept the intended purposes of Burns' demonstration—that a 3.5 per cent growth rate projected from mid-1947 through 1960 would show no GNP gap in 1960 —would imply that unemployment averaging about 6.0 per cent of the civilian labor force would be consistent with reasonably full utilization of resources. This implication is indeed wrongful.

This debating point scored by the advisers, although valid as a rebuttal of Burns, serves in fact to undermine one of their own main theses. For, in my view, it thoroughly discredits their thesis that a 3.5 per cent growth rate could maintain reasonably full employment over a substantial number of years.[6] Indeed, when the economic advisers admit that a more satisfactory rate of utilization than we have had would mean higher productivity gains and more entries into the labor force than were induced by a lower rate of utilization, they virtually admit that a 3.5 per cent growth rate from mid-1955 on would not have maintained reasonably full employment. In fact, the combined labor force and productivity factor that they used to arrive at this 3.5 per cent rate is much lower than any actual figure that has resulted during any substantial period of full employment within the most recent decades.

This ties in with my conviction that the economic advisers' general analysis is faulty in important respects. They seem to say, in their reply to Burns, that the GNP gap in 1960 was due to the failure of aggregate demand to keep up with a 3.5 per cent annual increase in potential supply, and that the task of recovery therefore centers largely on measures to expand consumption (which here may be taken to include demand for ultimate products in the form of both private consumer expenditures and public outlays). But then they go on to say that a growth rate higher than 3.5 per cent, after reasonably full use of resources is attained, depends not upon relatively more policy stress on the expansion of consumption, but rather upon relatively more policy stress on the expansion of private investment in plant and equipment. This, as I shall develop more

[6]See March 6, 1961 testimony.

fully later, seems based on two serious errors: (1) an assumption that equilibrium at maximum resource use may be sustained at a 3.5 per cent GNP growth rate; and (2) an assumption that a higher sustained growth rate after full recovery, depending as it does upon productivity advances averaging in excess of 2.0 per cent per annum, cannot be expected without a strong relative policy shift from consumption toward private investment in plant and equipment. I do not believe that the advisers would have made these errors if they had carefully analyzed the actual causes of the roller-coaster performance during 1953-60, the low economic growth rate, and the retreat from reasonably full resource use.

I feel that the economic advisers are indubitably correct in arguing that the President's spending program is not too high from the economic viewpoint, but they do not offer evidence that it is high enough. In recognizing that all government spending programs must meet the test of social priority, they are a million miles ahead of Burns, who apparently holds the view that public spending should be restrained both in the short run and in the long run without regard to social priorities. And even if Burns were correct in his assertions that higher levels of public spending would bedevil the inflationary problem and our international balance of payments problem if coupled with the rates of private outlays that he assumes, then he should urge that higher taxes be imposed in ways designed to restrain luxurious private spending, instead of sacrificing our greatest national priorities. His total neglect of this problem seems woeful.

## PERFORMANCE ANALYSIS

After writing and speaking about growth rates and GNP gaps for many years, I certainly welcome the emphasis that the new economic advisers place upon these matters. But for concern with these matters to become more than a mere numbers game or a mere device for censoring a previous administration, it must be linked inseparably with very careful analysis of why we have done poorly, how much better we should do in future, and what private and public economic policies are needed to do better.

### Essential Tools

The minimum requirements for analysis that will serve as a guide to nation-wide economic policies are two. First, there needs to be constructed a detailed portrayal of the economy in action for a substantial number of years past. This portrayal, which has sometimes been called a "nation's economic budget," but which I have suggested calling an "American economic performance budget," should depict the main developments in production and employment, and define for purposes of critical evaluation how far these actual developments fell short of desirable and feasible objectives (both quantitatively and qualitatively in terms of priorities of private and public needs).

The performance budget should also analyze the various main flows of income and spending, as affected by market forces and by major private and public economic policies, and discern how these flows deviated from the requirements for optimum economic performance. And finally, the performance budget should delineate, subject to human fallibility, what alternative private and public economic policies, in their impact upon income flows and other motivating economic forces, would have brought actual performance closer to the optimum.

On the basis of this analysis of the past and other relevant factors, there should also be constructed an economic performance budget for a number of years ahead, embodying the same essential components. This should be used as a rigorous guide to important public policies at the federal level, and as a consensual or voluntary guideline to private economic policies of nation-wide significance.

Neither the Council of Economic Advisers nor the President has thus far revealed such a performance budget to the public. I believe a budget of this kind essential if the Congress and the people are to understand our situation. Further, it would appear that

the council so far has not been guided by the development of such a performance budget even within its inner offices. Only the lack of such a budget explains how the very able members of the council could have developed (in the judgment of many excellent economists) programs and policies so far short of what is required for the tasks at hand.[7]

Aside from the quantitative insufficiency of the programs and policies set forth, the absence of a performance budget means that in large measure these programs and policies have had no common frame of reference, have not been adequately tested for consistency, and in part have been misdirected. To spell out these assertions, I need to indicate some of my own findings.

## POOR PERFORMANCE TO DATE

Basically, I believe that our poor economic performance since the end of the Korean conflict has been due to the failure of effective aggregate demand to keep up with and make use of the *actual* growth in the labor force and productivity.[8] This explains the long and increasing departure from maximum employment and production. It is also true that the actual growth in the labor force, and especially in productivity, would have been considerably higher if the large and growing economic slack caused by the inadequacy of aggregate demand had not seriously repressed the growth rate in both of these factors.

It follows from this analysis that we would have needed very specialized measures to improve the quality and structure of the labor force and to accelerate productivity growth (such as some specialized incentives to investors) if we had wanted to maintain an average annual GNP growth rate anywhere approximating the World War II annual average rate of about 9 per cent in real terms. We would, however, without such specialized measures have averaged an annual growth rate since 1953 well in excess of 4 per cent merely through the impact of an adequate level of aggregate demand upon utilization and growth in the labor force and productivity.

For the period 1953-60 as a whole measured at actual price levels, there were deficiencies in public outlays, occurring almost entirely at the federal level, as the states and localities strained their resources to advance as fast as they could. There were deficiencies in private consumer outlays, resulting in part from unsatisfactory income distribution affecting the relative propensity to spend and to save, but resulting more importantly from deficiencies in consumer incomes. These deficiencies included the gross deflation of farm income, the inadequate advance of both total wages and wage rates in the overall, and the miserable reluctance to expand sufficiently such consumer-oriented public

[7]In *Business Week* (October 14, 1961), pp. 34-36, there appears an article entitled "CEA's Model of Growth," which contains a tableau of figures entitled "Targets for 1963," prepared by the Council of Economic Advisers. In a very fragmentary way, this appears to be a very small first step toward something similar to an economic performance budget. But this tableau does not contain enough refinements to be very useful; it does not cover enough years nor a long enough time span; it does not develop any integration between goals and policies; and it does not indicate why the goals for 1963 are judged to represent a sustainable equilibrium model. I do not believe that the respective goals for private investment, personal consumption, and government purchases can represent an equilibrium model. Further, I do not believe that the CEA targets, even if achieved, are high enough to restore reasonably full employment of man power and plant by 1963, much less earlier, nor are the policies elsewhere urged by the President and by the CEA sufficient to achieve even these inadequate targets for 1963. In the *Business Week* article, the Chairman of the CEA is quoted as saying that "the whole project may just fizzle out" and that "the President likes the idea." This trial balloon is a far cry from recognition that the setting of such targets, and even more comprehensive ones, is specifically required by the Employment Act of 1946. The council has not yet made available to the public any model comparisons of actual past performance with the needed levels of performance for that period, which are essential to formulation of sound corrective policies for the future. There are errors in the council's targets for 1963 that would not appear if they had made a thoroughgoing analysis of unfavorable developments and their causes since early 1953.

[8]The following discussion, using an economic performance budget that I have reformulated for many years, is greatly amplified in *Jobs and Growth* (Washington 6: Conference on Economic Progress, 1001 Connecticut Ave., N.W., May, 1961).

programs as old age insurance and pensions, welfare spending, and minimum wage protection.

The deficiency in private business investment, which occurred for the period as a whole but not throughout the period, was not occasioned by harshness in the tax laws, nor by inadequate levels of profits and funds and other incentives during the boom periods. Rather, this deficiency reflected the sharp cutbacks in profits and incentives and business investment that occurred when the booms were followed by stagnation and recession, because of the insufficient demand for ultimate products on the part of consumers and governments. During the boom periods, indeed, the relationship between prices and wages in the key industries resulted in relative trends of profits and wages that yielded increasing profit margins per unit of sales and nonsustainably high rates of investment in plant and equipment.

As a result, these got further and further out of line with effective increases in real wages and other sources of ultimate buying strength. For example, during the period 1954-56, investment in plant and equipment grew about eight times as fast as ultimate private and public demand, and grew about five times as fast during the period 1958-60. This analysis serves also to indicate the nature of the "new inflation" when it occurred, and the fallacy of attributing it to wage rate increases that allegedly necessitated price increases.[9] In addition to the inadequate level of federal outlays, the tax policy and the monetary policy imposed excessive restraints upon the over-all economy, and were much too regressive in terms of their relative impacts upon investment and consumption.

To quantify this analysis, the 2.5 per cent annual rate of economic growth for 1953-60 meant a loss of about 18.5 man-years of employment opportunity, and a production loss of more than $260 billion, measured in uniform 1959 dollars. The deficiency in private consumer expenditures was about $170 billion, in public outlays for goods and services at all levels about $30 billion, and in gross private investment including net foreign more than $60 billion. A substantial part of this investment deficiency, however, was in residential construction rather than in investment in expanding the means of production.

[9]For a fuller discussion, see *Inflation—Cause and Cure* (Washington: Conference on Economic Progress, July, 1959); and *Wages and the Public Interest* (Washington: Conference on Economic Progress, January, 1958).

## Future Policies and Goals

Even though we now happen to be in another boom period—albeit a seemingly weaker boom than preceding ones—I have already indicated that I see very little fundamental difference between our basic situation now and in earlier periods since 1953.

Consequently, our long-range economic policies, geared to an economic performance budget that is reasonably attuned to our growth potentials and that carefully analyzes the sources of our recent and current difficulties, should move along these lines: a much larger expansion of federal outlays, directed toward domestic programs so far as not needed for immediate international purposes; great expansion of the public programs, such as social security, that increase consumer incomes by means other than direct federal spending; development of guideline studies pointed toward formulas for wage rate increases that, consistently with a stable price level, will help wages to exert their appropriate role in the expansion of total consumption; and vigorous measures to lift farm income through adjustment of supply and expansion of demand both at home and overseas. For reasons already stated, I believe that such efforts would induce an entirely adequate level of business investment, and, indeed, the real problem would again be to prevent this investment from becoming too ebullient.

Such a combination of policies would balance the federal budget or even yield a surplus in those years when we were close enough to full resource use to justify such tight budget policies. Actually, current tax rates are in the main too high for this purpose because they would yield a surplus far

short of full resource use, and there should be some tax reductions favorable to low-income and middle-income consumers. There should also be considerably more liberalization of monetary policy, with lower long-term and short-term interest rates.[10]

I shall now quantify these objectives in order to indicate their implications, restricting myself here to the goals for 1962. I developed these early in 1961, consistent with long-range goals through 1965. While it now seems almost impossible that these goals could be attained in 1962 because of neglect, they are nonetheless indicative of the nature of the tasks ahead. Compared with fourth quarter, 1960 (annual rates seasonally adjusted), total national production should be up $86 billion in 1962; private consumer spending up $46 billion; wages and salaries up $43 billion; net farm income up $6 billion; transfer payments up $8 billion; gross private investment up $23 billion; residential nonfarm construction up $8 billion; and public outlays for goods and services up almost $14 billion at the federal level, and more than $4 billion at the state and local level.[11]



## CURRENT INADEQUACIES

### Inadequacies in Policies

It is discouragingly obvious that little of the official programmatic thinking is in line with this analysis or adjusted to these goals. I feel this way not only about the short-range economic outlook (which I have already discussed in citing the employment and production trends thus far) but also about the long-range outlook. Even if the Congress were to respond favorably and quickly to all that the administration has so far proposed, including the logical expansion in future years indicated or implied, I question seriously whether our average annual growth rate during the five-year period 1961-65 would be appreciably higher than the dismally inadequate rate during 1953-60.[12] My estimate is that we would forfeit during the five-year period 1961-65 another 20 million man-years of employment opportunity and, measured in uniform 1959 dollars, another $390 billion in total national production. This could leave us in 1965 alone, even if that did not happen to be a recession year, with true unemployment of about 9 million and a production deficiency of about $120 billion, again measured in uniform 1959 dollars.

### Errors in Tax Approaches

A significant example of faulty analysis is the proposal for special tax concessions to investors made by the President earlier this year with the public support of the Council of Economic Advisers. While this proposal was not adopted, it is generally believed that the Secretary of the Treasury and others are developing an even broader range of tax concessions for presentation next year. In recent weeks, in fact, the Treasury has granted some tax concessions to encourage investment in plant and equipment.

The main reasons advanced by the Council of Economic Advisers for this kind of tax thinking is that a GNP growth rate much above 3.5 per cent annually, after full recovery is achieved, depends upon an annual productivity growth rate much higher than 2.0 per cent (assuming a growth rate in the labor force of about 1.5 per cent); that this higher growth rate in productivity requires a much higher ratio of business investment to GNP than has pertained in recent years; and that this in turn requires special tax concessions.

Let us put aside the point that we need to achieve full economic restoration before we start sustaining it, and that stimulating investment relative to private and public demand for ultimate products would seem foolish until after full recovery. But even thereafter, granted that the average annual growth rate both in productivity and in the

[10]See *Tight Money and Rising Interest Rates* (Washington: Conference on Economic Progress, July, 1960); also *Jobs and Growth*, chapter 10.

[11]*Jobs and Growth* develops and reconciles all these quantifications in much greater detail. An economic performance budget through 1965, including programs and policies, is also given.

[12]For detailed reasoning, see *Jobs and Growth*, especially Chapters 6 and 9.

investment that affects it have *averaged* much too low since 1953 as a whole, the reasons for the low growth rate in investment have been entirely different from those that might call for tax concessions. And the reasons for the low productivity growth rate average have been only in part technological; to a large extent, they have been due to economic slack—a fact that the advisers admit. In addition, the advisers have adduced no arguments in support of their claim that the ratio of investment to GNP should be higher for the long pull than in recent years, except reasoning by analogy to the years immediately following World War II, which involved entirely different problems. Furthermore, there is no indication that an adequate level of ultimate demand has not induced an adequate ratio of investment to GNP—in the past, the ratio when ultimate demand was high has tended to get too high and to get us into trouble.

In any event, measures to provide special incentives to investors should be accompanied by compatible measures to help expand other sectors in order to provide equilibrium. The idea that high investment is automatically sustainable is negated by all experience. But without a performance budget, the tax ideas of the advisers have been developed in a void, and have no contact with reality.[13]

There is other evidence that the economic advisers do not yet have the comprehensive view of the economy and the integrated approach to policies that a performance budget would provide. In their testimony before the Joint Economic Committee on March 6, 1961, the advisers stated that the personal saving ratio during the last half of 1960 was "abnormally high." To a question posed by a member of the committee, the advisers subsequently replied:

"Strength in consumer spending would be a welcome stimulus to our economy, which is suffering from inadequate demand. But a low saving ratio is not a *sine qua non* of recovery if investment or public expenditure expands sufficiently. The higher the personal saving ratio, the more the burden in restoring and maintaining full employment falls on investment demand. If investment demand is to expand sufficiently, both the tax system and the monetary policy must provide adequate incentives to investment. There are advantages to a sustained prosperity of this kind."[14]

This seems to me an extremely superficial statement. It reflects a common error of the economic model makers who stop short of the real problem, namely, the error of assuming that a level of GNP high enough to sustain full prosperity can result merely from playing around with the figures representing the components of GNP until these figures add up to the desirable GNP.

The error begs the whole question of a sustainable relationship between the expansion of productive capacities and the expansion of demand for ultimate products. This is the essential problem in the American economy. It is a problem that the advisers, in their public analysis and policy discussions to date, have hardly touched. If they came to grips with this problem, they would change many of their ideas, including their ideas concerning taxes. They might find, for example, that the propensity of consumers to spend might be encouraged if tax changes were directed toward improving the distribution of personal income after taxes, and that these types of changes would, on grounds of both equilibrium and equity, be far safer and sounder than using tax concessions to stimulate some more nonsustainable investment booms.

### Errors in Price-Wage Approaches

In their increasing preoccupation with an inflationary problem, which has been grossly exaggerated for bad purposes in recent years and which in any event has been due to causes other than those usually blamed for it, the economic advisers and even more so the President are whipping the country into a frenzy about "restraining prices and wages." Of course, both need to be restrained—if restraint is interpreted as avoiding excesses. But the central economic problem is to get a proper relationship be-

[13]See *Jobs and Growth*, pp. 71-73.

[14]Hearings before the Joint Economic Committee on April 10, 1961.

tween prices and wages. The central difficulty in recent years has been that prices have been too high relative to wages during the unbalanced boom periods that have generated the seeds of recession. The problem will not be resolved by a mere propaganda campaign that is likely to result in a still worse relationship and therefore still worse economic consequences, even if some price restraint occurs along with even more wage restraint.

If the government is to concern itself at all with guidelines to prices and wages, and I believe that it should, then the government through the Council of Economic Advisers and other instrumentalities should recognize the responsibility to quantify the price-wage problem and to relate it to other aspects of an economic performance budget. By doing this, they would be providing real economic leadership instead of looking for applause from a general public that may be applauding the wrong rather than the right policies just because the government is reinforcing miseducation instead of providing education.

## THE FAULTY 3.5 PER CENT GROWTH RATE

Both the tax mistake and price-wage mistake proceed from the economic advisers' faulty conclusion that a 3.5 per cent GNP growth rate is "normal" and consistent with sustained full employment after it is achieved. This conclusion, since it is based upon the idea that a 2.0 per cent average annual increase in productivity is normal, leads naturally to the idea that a 2.0 per cent nation-wide average increase in wage rates would be about correct. It also leads to the conclusion that, in order to get a higher GNP growth rate, tax policies must be used as the advisers suggest.

However, the 3.5 per cent figure, for the purposes used by the advisers, would not seem to bear close scrutiny. To be sure, during the four decades 1922-60 (1922 being an appropriate base year after World War I), the average annual rate of growth in total national production was 3.4 per cent, measured in uniform 1959 dollars. And if we exclude the Great Depression and the far from satisfactory recovery during the period 1929-39, the World War II and reconversion years 1939-47, and the Korean conflict years 1950-52, the average annual rate of growth since 1922 was about 3.7 per cent.

But this 3.7 per cent figure is a very long-term average performance that spans good and bad years. It includes the years 1953-60, when the average annual growth rate of only 2.5 per cent carried us further and further away from maximum employment and production. The growth rate has been much higher when our resources were in even moderately full use. The average annual growth rate was more than 4.5 per cent during the peacetime prosperity period 1922-29, which was not characterized by excessive pressure upon productive resources or by an "undesirably" low level of unemployment. During the predominantly peacetime period 1947-50, the annual average was about 4.0 per cent, despite a somewhat high average level of unemployment and one substantial recession. And during the period 1947-53, divided somewhat equally between peacetime and limited war and therefore roughly comparable as a whole to the period since 1953, the annual average growth rate was 4.8 per cent, despite average employment considerably below maximum.

In view of this record, my estimate—that an average annual growth rate of about 4.2 per cent during the period 1953-60 would have been consistent with sustained maximum utilization of our growing productive resources—is perhaps conservative. Indeed, if we go all the way back to 1922, no period of significant length can be found in which a lower growth rate resulted in anything approximating maximum employment and production. In view of the productivity trends discussed below, I estimate that an average annual growth rate of about 5.0 per cent, or only very slightly higher than the 4.8 per cent rate during the period 1947-53, would be the optimum for the years immediately ahead, once maximum employment and production are restored. To return to full prosperity by the end of 1962, an average annual growth rate of about 8.0 per cent would be required in 1960-62. We are not likely to achieve it.

### Vulnerable Productivity Analysis

Nor is there much support in the data for the economic advisers' idea that it is reasonable to expect only a 2.0 per cent average annual growth rate in productivity under conditions of fairly full resource use. The average annual growth in productivity for the entire private economy is estimated at 0.5 per cent during the period 1910-20; it accelerated to 2.4 per cent during the period 1920-30; and it accelerated further to 2.6 per cent during the period 1930-40. During the most recent of these three decades, the continued advance in technology more than counteracted the adverse effect upon productivity of depression levels of unemployment. Indeed, it may be that the brutal disemployment of workers during the Great Depression sacrificed nation-wide efficiency to per-unit "efficiency." The period 1940-50 showed an average annual productivity growth rate at the still faster rate of 3.0 per cent, with a higher rate in the post-World War II period.

As a whole, the most recent ten years have shown a serious decline in the rate of productivity growth. But this adverse trend did not start at the beginning of the decade. During the period of reasonably full employment, 1947-53, the average annual rate of productivity growth had accelerated still further to 4.1 per cent. And even during the period 1950-55, in which conditions of moderate economic slack prevailed, the productivity growth rate averaged 3.8 per cent, or much higher than the 1940-50 average. But during the 1953-60 period, a period of relatively large economic slack, the productivity growth rate averaged only 2.6 per cent; and during the 1955-60 period, a period of still greater economic slack, the productivity growth rate fell to an average of only 2.1 per cent.

Since, broadly speaking, progress in science, technology, and automation has continued to accelerate, this disturbing decline in the productivity growth rate has not been due primarily to deficiencies in technological capabilities. Instead, it has represented considerable inefficiency in the use of man power and existing plant and equipment, brought about by large and growing economic slack. Moreover, under the incentives of higher ultimate demand, our technological capabilities *in being* would have increased through investment much more rapidly than they actually did.

In their March 6, 1961 testimony before the Joint Economic Committee, the President's economic advisers stressed the fact that productivity gains are adversely affected by economic slack, and that productivity speeds up greatly as the economy moves closer to full operation. Indeed, the advisers point out that, during periods when unused capacities are being sharply reduced, the average annual productivity gains tend to be about 3.3 per cent. There is no reason to assume that these gains would be lower at reasonably full utilization of capacities; in fact, they might well be higher.

Department of Labor studies and statements by the Commissioner of Labor Statistics reinforce the proposition that there has been a distinct acceleration in the rate of productivity gains in the private economy during the past five decades. The relevant productivity figures derived by the Bureau of Labor Statistics indicate an annual productivity gain potential ranging between 3.5 and 3.9 per cent under conditions of high capacity utilization.

These results are all consistent with the proposition that an average annual GNP growth rate of about 5.0 per cent would result in the years shortly ahead if reasonably full utilization of resources were maintained. The main policy measures put forward by the economic advisers to lift the growth rate above 3.5 per cent do not, however, correctly size up the elements in the problem; indeed, these policies would work against rather than in favor of equilibrium at full prosperity.

### Policy Deterioration

In recent months and weeks, there have been no indications that the government is improving its thinking or sharpening its tools in order to achieve more rapid economic recovery or more adequate growth.

For example, at the technical level, we hear more and more to the effect that pro-

grams which might well serve these purposes must be held in check in view of our international balance of payments problem. As the general economic policies of the administration move closer and closer to those of the previous administration, the balance of payments problem—real though it is—is being used in a scare campaign to turn us away from much of what we need to do. Similarly, the real aspects of the inflationary problem were pumped up into a scare during the Eisenhower administration for the same purpose.

If the economic advisers used an economic performance budget to integrate a thorough analysis of our international economic problems with our domestic economic problems, they would soon discover that a sustained and adequate rate of economic growth in the United States would do more than all else to reduce the real or alleged overseas competitive threat to our well-being, not to speak of improving overseas confidence in the American economy and therefore the American dollar. In addition, the advisers ought to be helping the President to tell the country that new instrumentalities can be devised to reduce our slavish dependence upon gold, and to maximize the real wealth and prospects that we are now sacrificing by our reliance on outmoded shibboleths. Unfortunately, the advisers seem most recently to be abetting rather than resisting the faulty use of the balance of payments problem.[15]

The economic advisers may also be taken to task for joining in, instead of continuing to resist, the rosy optimism now pervading the administration on the economic front. When high technicians in even the Department of Labor put in their press releases no better explanation of the failure to reduce unemployment in September than hurricane "Carla," when Cabinet officers and economic advisers are talking about a recovery that has "exceeded our highest predictions," and when some of them who should know better are saying that the only remaining unemployment problem is "hard core" or "structural," I shudder to think of our economic future in the face of world events.

[15]For a fuller discussion of the gold and balance of payments problem, see *Jobs and Growth*, Chapter 11.

### POLITICAL POSTSCRIPT

At the outset, I promised to say a word on the "political" subject as it interpenetrates with policy at the national level. Some of my friends in the administration tell me that everyone there, including the President, wants to do much more on the economic front, but that there are "political" problems. There always are.

Political difficulties, however, do not explain some of the deficiencies in the work of the economic advisers, and, through them, in the economic programs of the President. Political difficulties do not entirely explain the number of appointments to top positions, which, far from strengthening the administration forces and thus helping to educate a Congress and public that the administration says are too static or too apathetic, are instead adding to the static forces within the administration itself. The genuine political problems confronting the President do not justify the rationalizations of the economists close to him, both inside and outside the government, on behalf of programs they know to be deficient. This robs the President of the services that such economists should render, the help that they should give him in his weighing of the political risks of asking for too much against the national and international risks of trying to get along with too little.

And even from the viewpoint of political strategy, one now sees an administration that has blurred some of the vital issues in its desire to win "conservative" approval being forced to undertake a special campaign to win over those who are castigating it (as might have been expected) despite its placatory efforts. Thus, one wonders whether it would not be better political strategy in the long run to tell the American people what we may need to do in order to survive.

Be this as it may, the thoughtful and responsible economist in the years ahead is challenged to do his part to help lift the government and the American people from the foothills to the mountains in dealing with the urgent problem of economic growth.

# CAN THIS OIL INDEPENDENT MAKE IT?

Case Study



Over the past few years, the management of the Franklin Oil Refining Company has been studying the effects of the major oil companies' accelerated program of acquisition of independent filling stations. The company has determined that this acquisition trend, if unchecked, will eliminate many of Franklin's good customers and seriously affect the profitability and long-run prospects of the company.

In 1940, the incorporators of the Franklin Oil Refining Company recognized an opportunity to capitalize on the demand for residual fuel oil required by the foundries in Columbus, Ohio. They obtained an option on a suitable tract of land, which was well outside the city limits and was crossed by a pipeline that brought crude oil from the Texas fields. With the refinery facilities in operation, Franklin officials believed their company could deliver residual fuel oil locally at a lower cost than could the larger oil companies; these companies were obliged to use rail transportation to bring oil from their refineries, which were located at a considerable distance. The advantage thus gained on residual fuel oil was counted on to put Franklin in position to meet the tank-truck prices regularly quoted on gasoline by the major oil refiners and still make a satisfactory profit.

The strict limitations on the consumption of petroleum products, which were instituted immediately after the attack on Pearl

*The data for this case study were collected by the Case Research Unit of the School of Business, Indiana University, and prepared by Glenn D. Babcock.*

Harbor in 1941, posed very difficult problems for the new oil company, but these were coped with successfully. Franklin entered the 1950's in a good position financially and with every indication of a profitable market for the capacity of the refinery.

## THE INDEPENDENT OPERATOR

It was not long, however, before changes occurred in the retailing of gasoline. Before World War II and for a short time after the war, a large amount of capital was not required to open a filling station. The stations were neither large nor elaborate, and a man with $500 usually had little difficulty in making arrangements for financing the construction of a station and the installation of tanks, pumps, and other equipment. But as the more favorable locations were taken, owners began erecting larger stations and adding fully equipped facilities for lubricating and servicing cars. Inefficient or inadequately financed operators either went out of business or sold their stations to more capable and aggressive operators. Numerous small chains of filling stations came into existence, and many of these chains, as well as the operators of single stations, were good customers of the Franklin Oil Refining Company.

### PRICE WAR LOSSES

The keen competition among all the stations owned or leased by independent operators and all the stations operated by the major oil companies forced down the retail margin of profit. Inevitably an operator, or perhaps one of the larger companies, would offer some inducement to attract trade. Whatever form this inducement took—a lower price per gallon of gasoline, trading stamps, or some other type of promotion—the other stations could be expected to make a counter effort to hold their trade. Not only was the first station's special inducement met, but frequently it was surpassed, and a price war ensued. Sometimes these wars were short lived, but many times they continued for extended periods, during which the prices were forced down to a level at which no one could break even, let alone make a profit.

Companies with widespread distribution were able to absorb the losses incurred in a local price war, but the independent operator whose capital was invested in the single station or in a small chain with most or all units in the area affected by the price war had no way to offset his losses. By the late 1950's, several important chains had sold out to one or another of the major oil companies. Whenever this happened, the Franklin Oil Refining Company's market, either actual or potential, was reduced. The situation was aggravated by the larger companies' stepped-up programs of expansion of their retail outlets in the Middle West.

### CAPITAL GAINS TAX

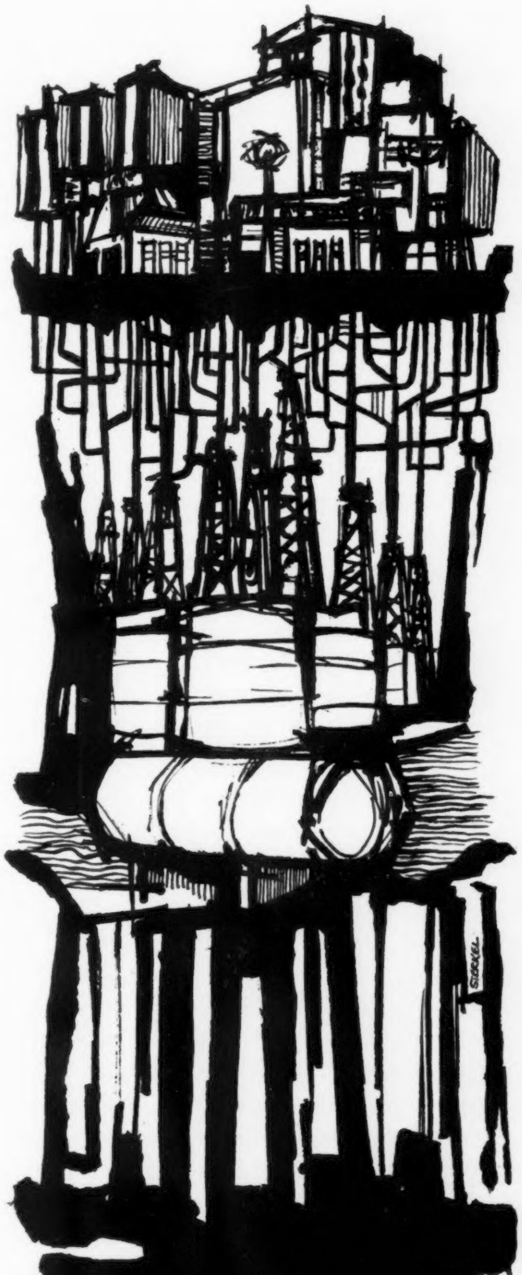
The Franklin Oil Refining Company was not in a good position to protect itself against loss of outlets by purchase of small chains of stations when they came on the market. Under existing regulations of the Internal Revenue Service, an owner of a chain could negotiate a tax-free exchange of the stock of his corporation for stock in a major oil company and thus avoid the capital gains tax. Ordinarily, stock in a company whose shares are listed on the exchange is much more attractive than unlisted shares in a smaller corporation such as Franklin. Consequently, if Franklin wished to purchase a chain of stations offered for sale, or if it chose to act as an intermediary and interest some other operator in the purchase, it was necessary for the cash offer to be sufficiently larger than the market value of the traded securities to offset the capital gains tax.

For example, the owner of a chain of approximately forty stations, including four bulk plants and certain other property, had decided to sell and asked $1,450,000 for his holdings. A widower over sixty years of age, he desired to convert his estate into negotiable securities that could form the basis of several trusts for his one married daughter and her children. His attorney had informed him that his estate would be exposed to a

cost of from $100,000 to possibly $150,000 in legal fees for appraisal and handling of the physical properties of the chain if he still owned the corporation at the time of his death. In that event, however, no capital gains tax would be imposed, unless the law was changed.

The net worth of the corporation had been built up over many years. A considerable number of the sites had been acquired at very low prices, far below current values. The buildings and equipment had been largely depreciated. If the owner sold for cash, he was subject to tax on about $1,000,000 in capital gains. A cash purchaser, therefore, would have to pay him approximately $250,000 more than the value of securities that might be offered by one of the major oil companies in a tax-free exchange. C. H. Whitney, treasurer of Franklin, was reasonably confident the owner of this chain of stations would obtain his asking price.

Thus, said Whitney, the operation of the federal income tax as it applies to capital gains favored the acquisition of smaller corporations by the large companies, and worked against the growth of a corporation that was not in a position to work out an equally attractive tax-free proposal when it wished to purchase properties that came on the market. To illustrate the difficulties faced by an independent refining company in attempting to halt the inroads of the major oil companies, Whitney cited the case of the owner-operator of a small chain of stations. This customer, Apex Oil Corporation, with headquarters in Newark, Ohio, bought less than 1 per cent of Franklin's output, but was representative of customers comprising 40 per cent of Franklin's total market.



## APEX OIL

### Acquiring Stations

Henry Fleetwood, the president of Apex Oil, had formerly taught in a small rural school. In 1939, when the school trustee was changed, he was dismissed from his job. Having decided to get into some other line of work, Fleetwood found a filling station

under construction at the intersection of routes 13 and 40 south of Newark, Ohio. An employee of one of the local factories had leased a small plot with option to purchase, had contracted for underground tanks on a payment plan, and was attempting to construct the station during his off-hours. His funds were depleted, however, and his credit was insufficient to enable him to complete the station.

With a $500 loan for working capital from an aunt who also guaranteed payment of his obligations for additional equipment needed, Fleetwood obtained credit, completed the station, and was soon in business. His total investment was only about $2,500. Fleetwood proved to be a capable operator. His wife kept the records and sometimes even helped out on the driveway. The station prospered, and, when a major oil company closed a station in Newark because of depressed local conditions, Fleetwood was able to buy the station without any down payment. He operated these two stations successfully until 1943, when he leased two more stations—one in Columbus and one in Zanesville—that had been closed because of gasoline rationing. Fleetwood arranged to have these stations supplied by the Franklin Oil Refining Company.

During the next few years, Apex Oil purchased or built several more stations. Some of them did not prove successful, and some that had initially been successful did not continue to be so over time. A station in Utica, Ohio was a complete failure and was closed after only one month's operation. Another, located in Mt. Vernon, Ohio, also was unsuccessful and was later closed. Two stations in Mansfield, on the other hand, were very profitable. One was at the intersection of routes 42 and 30 near the eastern edge of the city; it pumped about 65,000 gallons a month during the first few years, and about 45,000 gallons a month during the last two years. Two more stations were opened in Columbus; one of these, located near the entrance to the fairgrounds, was later sold to another independent chain, and the other was sold when a large superstation with five islands and ten pumps opened within two blocks of it. A station in Coshocton did well until a large station was built just across the road; then the Apex station was sold. Better results were obtained from two more stations built in Zanesville.

During World War II and for some time afterward, Apex enjoyed a gross margin of 8 cents to 9 cents a gallon, and the return on investment was sometimes as much as 33 per cent before federal income taxes. Until 1954, Fleetwood's annual profits had ranged from $20,000 to $50,000.

### Increased Competition

Beginning about 1955, several of the major oil companies, which formerly had had little distribution in central Ohio, began aggressively to expand their operations in the area. They started buying properties and building very expensive stations; to attract trade, special inducements were offered with much publicity. Price wars were frequent. Those companies that previously had enjoyed the bulk of the trade were forced to expand in order to protect their "fair share of the market," and the competition for strategically located sites increased the price of real estate far beyond its true value. In many cases, formerly profitable businesses became marginal operations.

### Costs and Losses

Costs of erecting stations had increased greatly since Fleetwood's initial investment of $2,500 in his first station. Apart from the cost of land, which varied widely depending on the location and the competition for advantageously situated sites, the cost of an average one-island station had risen by 1959 to about $24,000, according to Bill Fleetwood, Henry's nephew and the vice-president of Apex. This cost was made up of approximately $14,000 for the building, $6,000 for tanks and pumps, and $4,000 to $5,000 for the driveway.

The Apex Oil Corporation had not favored the supermarket type of operation that some operators had adopted. Fleetwood felt it was better to have only one or two

## *APEX OIL CORPORATION*

### Profit and Loss Statements for Years 1956-60

| | 1956 | | 1957 | | 1958 | | 1959 | | 1960 | |
|---|---|---|---|---|---|---|---|---|---|---|
| Gross sales | $1,232,265 | 102.6% | $1,223,006 | 102.5% | $1,158,791 | 101.8% | $ 860,317 | 101.5% | $ 974,072 | 101.5% |
| Less discount and allowance | 31,002 | 2.6 | 29,817 | 2.5 | 20,264 | 1.8 | 12,390 | 1.5 | 14,673 | 1.5 |
| Net sales | 1,201,263 | 100.0 | 1,193,189 | 100.0 | 1,138,527 | 100.0 | 847,927 | 100.0 | 959,399 | 100.0 |
| Cost of goods sold | | | | | | | | | | |
| Inventory Jan. 1 | 19,598 | 1.6 | 18,522 | 1.6 | 19,538 | 1.7 | 15,246 | 1.8 | 18,233 | 1.9 |
| Purchases | 882,748 | 73.5 | 907,592 | 76.0 | 905,948 | 79.6 | 661,956 | 78.1 | 769,671 | 80.2 |
| Available for sale | 902,346 | 75.1 | 926,114 | 77.6 | 925,486 | 81.3 | 677,202 | 79.9 | 787,904 | 82.1 |
| Less: Inventory Dec. 31 | 18,522 | 1.5 | 19,538 | 1.6 | 15,246 | 1.4 | 18,233 | 2.2 | 19,186 | 2.0 |
| Cost of goods sold | 883,824 | 73.6 | 906,576 | 76.0 | 910,240 | 79.9 | 658,969 | 77.7 | 768,718 | 80.1 |
| Gross profit on sales | 317,439 | 26.4 | 286,613 | 24.0 | 228,287 | 20.1 | 188,958 | 22.3 | 190,681 | 19.9 |
| Expenses | | | | | | | | | | |
| Depreciation | 20,948 | 1.7 | 19,657 | 1.6 | 16,188 | 1.4 | 10,798 | 1.3 | 8,770 | 0.9 |
| Interest | 3,091 | 0.3 | 2,561 | 0.2 | 1,409 | 0.1 | 995 | 0.1 | 783 | 0.1 |
| Taxes | 9,443 | 0.8 | 10,567 | 0.9 | 8,766 | 0.8 | 7,004 | 0.8 | 8,140 | 0.8 |
| Administrative | 6,878 | 0.6 | 12,761 | 1.1 | 28,052 | 2.5 | 8,426 | 1.0 | 7,583 | 0.8 |
| Advertising and selling | 4,221 | 0.4 | — | — | — | — | — | — | — | — |
| Transport, trucks | 8,705 | 0.7 | 7,787 | 0.7 | 7,996 | 0.7 | 11,982 | 1.4 | 9,420 | 1.0 |
| Miscellaneous, general | 15,607 | 1.3 | 11,769 | 1.0 | 12,102 | 1.0 | 7,601 | 0.9 | 11,521 | 1.2 |
| Salaries and wages | 157,203 | 13.1 | 151,942 | 12.7 | 113,226 | 9.9 | 94,415 | 11.1 | 102,194 | 10.6 |
| Rent | 36,457 | 3.0 | 46,802 | 3.9 | 27,931 | 2.5 | 26,156 | 3.1 | 21,167 | 2.2 |
| Renewals and repairs | 6,124 | 0.5 | 11,689 | 1.0 | 3,427 | 0.3 | 3,355 | 0.4 | 11,231 | 1.2 |
| Utilities and heat | 9,032 | 0.7 | 8,377 | 0.7 | 6,435 | 0.6 | 5,588 | 0.7 | 6,441 | 0.7 |
| Telephone | 730 | 0.1 | — | — | — | — | — | — | — | — |
| Office supplies | 2,172 | 0.2 | — | — | — | — | — | — | — | — |
| Insurance | 5,119 | 0.4 | 4,566 | 0.4 | — | — | — | — | — | — |
| Total expenses | 285,730 | 23.8 | 288,478 | 24.2 | 225,532 | 19.8 | 176,320 | 20.8 | 187,250 | 19.5 |
| Net profit (loss) | 31,709 | 2.6 | (1,865) | (0.2) | 2,755 | 0.3 | 12,638 | 1.5 | 3,431 | 0.4 |
| Other income | | | | | | | | | | |
| Discounts earned | 5,807 | 0.5 | 6,078 | 0.5 | 5,713 | 0.5 | 3,880 | 0.5 | 4,381 | 0.5 |
| Profit (loss) on sale of equipment | 99 | — | 5,962 | 0.5 | 22,996 | 2.0 | 71 | — | (780) | (0.1) |
| Total of other income | 5,906 | 0.5 | 12,040 | 1.0 | 28,709 | 2.5 | 3,951 | 0.5 | 3,601 | 0.4 |
| Loss on oil well operation | (935) | (0.1) | — | — | — | — | — | — | — | — |
| Net profit before federal income taxes | $ 36,680 | 3.0% | $ 10,175 | 0.8% | $ 31,464 | 2.8% | $ 16,589 | 2.0% | $ 7,032 | 0.8% |

islands with two or four pumps and be able to maintain a more personal contact with the customers than was possible in the larger stations. He also believed he could get a better attendant and have closer supervision over employees in the smaller stations. It had been his observation that most customers preferred to trade at a station where they knew the attendant and where they knew the station would be open whenever they stopped for gasoline. All but one of the Apex stations were kept open twenty-four hours a day. In this manner, Fleetwood felt that maximum gallonage per pump was obtained and the greatest return on investment assured.

Apex did not have any grease racks with its stations. Bill Fleetwood contended that the wages of an extra attendant, who might lubricate ten cars a day, were entirely out of proportion to the charges for the service, and gallonage suffered if one man attempted to work on the grease rack while servicing the gasoline pumps. A large chain had made a test in three of its stations in Cleveland and Akron, he said, and had found that customers objected to waiting for the man at the grease rack to take care of them, and to have him come out to their cars with his hands greasy. He said the test results indicated that gasoline sales had fallen off as much as 30 per cent because of the racks. Those stations that still maintained grease racks did so, Bill claimed, only as a convenience to the customer and not because the service was profitable.

Between 1955 and 1958, Henry Fleetwood inaugurated many efficient measures, and marginal stations were either closed or converted to other uses. In 1957 and 1958, an oil company that previously had not had distribution in the area erected several sta-

## *APEX OIL CORPORATION*

**Balance Sheets for Years 1956-60**

**Assets**

| | 1956 | 1957 | 1958 | 1959 | 1960 |
|---|---|---|---|---|---|
| Current assets | | | | | |
| Cash | $ 3,883 | $ 4,694 | $ 1,837 | $ 1,342 | $12,906 |
| Accounts receivable | 8,407 | 10,603 | 10,857 | 16,616 | 19,443 |
| Inventories | 18,522 | 19,538 | 15,246 | 18,233 | 19,186 |
| Total current assets | 30,812 | 34,835 | 27,940 | 36,191 | 51,535 |
| Fixed assets | | | | | |
| Land | 2,764 | 2,764 | 564 | 564 | |
| Buildings | 72,205 | 67,531 | 22,555 | 25,258 | 25,666 |
| Equipment | 49,098 | 43,900 | 29,600 | 28,760 | 17,714 |
| Trucks and automobiles | 23,476 | 21,027 | 17,718 | 17,718 | 27,248 |
| Total | 147,543 | 135,222 | 70,437 | 72,300 | 70,628 |
| Less: | | | | | |
| Allowance for depreciation | 55,047 | 62,800 | 35,629 | 46,243 | 35,917 |
| Total fixed assets | 92,496 | 72,422 | 34,808 | 26,057 | 34,711 |
| Prepaid expenses | 183 | ...... | 287 | 927 | 2,812 |
| Total assets | $123,491 | $107,257 | $63,035 | $63,175 | $89,058 |



**Liabilities and Net Worth**

| | 1956 | 1957 | 1958 | 1959 | 1960 |
|---|---|---|---|---|---|
| Current | | | | | |
| Accounts payable | $ 30,434 | $ 34,731 | $15,702 | $23,541 | $46,069 |
| FICA and withholding taxes payable | 1,709 | 1,238 | 987 | 1,216 | 1,375 |
| State gasoline tax payable | 12,292 | 13,380 | 13,888 | 16,233 | 17,319 |
| Notes payable | 5,000 | 10,000 | 8,875 | 8,000 | 23,836 |
| Total current liabilities | 49,435 | 59,349 | 39,452 | 48,990 | 88,599 |
| Long-term debt | | | | | |
| Notes payable | 36,575 | 26,275 | ...... | ...... | ...... |
| Net worth | 37,481 | 21,633 | 23,583 | 14,185 | 459 |
| Total liabilities and net worth | $123,491 | $107,257 | $63,035 | $63,175 | $89,058 |

tions in Newark. During the price war, which started shortly thereafter and lasted three or four months, the price of standard grade gasoline dropped from 29.9 cents to 24.9 cents per gallon, leaving only about 2.0 cents margin for the Apex stations. According to Bill Fleetwood, it was commonly understood that the lessees of the major company's stations were guaranteed a margin of 4.5 cents per gallon during the price war. With the increased consumption of gasoline while the low prices were in effect, those operators were satisfied, but it was impossible for an independent operator such as Apex to show a profit since most of its stations were in the affected areas. (Financial data for the company are shown in the accompanying balance sheet and profit and loss statement.)

### APEX'S ALTERNATIVES

Prices were returned to the normal level during the latter part of 1958, but another war broke out in 1959. Once again, it was several months before the ruinous competitive situation was righted. Fleetwood was compelled to sell some property in order to provide funds for living expenses. By early 1960, he was very discouraged. The price wars in the cities in which his stations were located threatened to recur repeatedly.

Fleetwood saw two alternatives: to spread his operations to other towns where price

wars were not occurring, or to sell his entire business to one of the major companies. The first alternative would require additional funds, but, in view of the unsatisfactory profit history in recent years, his ability to raise such funds was questionable. Would a realistic estimate of net earnings after taxes be large enough to offset the chance of loss in the new locations? Would he be justified in risking possible loss of all his savings? Did he not owe it to his wife and their three children to get out of the business? The eldest son was a freshman at Ohio State, and Fleetwood certainly did not want anything to interfere with his education or the education of the other children.

Fleetwood seriously considered selling out and investing the proceeds after taxes in stocks of large companies with good dividend records. Possibly he could work out a merger of his chain with one of the major companies, exchanging stock in a tax-free transaction, and accept a salaried position with that company. Some features of such a proposition did not appeal to Fleetwood, but he still felt it might be the wisest choice.

Since the Franklin Oil Refining Company had been his principal source of petroleum products for almost all the years Apex had been in business, Fleetwood discussed his problem with his friend Whitney. Whitney advised Fleetwood against entering another line of business unless he could work out some way of avoiding payment of high income taxes on the earnings that should be anticipated to justify the venture with its concurrent risk of possible loss of his investment.

At the same time, Whitney did not foresee any long-time suspension of price wars, considering the legal prohibitions against price agreements between competitors. The world supply of crude oil now exceeded any short-run needs, and as long as integrated companies could get a profitable price for crude they could be expected to sacrifice distribution profits if necessary to maintain flow at the wellhead.

Should Fleetwood decide to try to continue the Apex Oil Corporation, it was Whitney's opinion that Fleetwood should expand into other towns to lessen the risk of the effect of a price war on all his stations at the same time. However, Whitney believed the erection of the kind of facilities that would be needed to meet existing competition would require more funds than Apex could expect to obtain through normal channels.

## COMMENT *Charles M. Hewitt*

THE HIGHLY competitive situation in which the Franklin Oil Refining Company and Apex Oil Corporation find themselves is similar to the situation faced by smaller firms in many American industries in recent years. The competition in gasoline marketing, however, is aggravated by special factors that exist in the petroleum industry.

About twenty very large, fully integrated major companies own or control most of the industry assets at all levels of the industry. These major companies are not only in a position to take advantage of varying profit opportunities at any level of the industry, but, by their policies, they can also substantially influence the margins to be earned at any given level.

Special tax considerations relating to the production level of the industry and technological factors relating to refining have resulted in major company policies that tend to focus the brunt of competitive pressures in the industry at the marketing level. A succinct description of this tendency appeared in *Fortune* magazine more than twenty years ago:

> "It is . . . clearly in the interest of large integrated companies to keep profits locked securely in the crude oil . . . far away from the point where the refined products meet the pressure of the market. Under such a system gasoline price wars, touched off by dealers, are incessant; but the marketing companies usually cushion the shock before it gets to the crude margin. The general strategy of running an oil company might be defined thus: make

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big profits on the crude; protect the profits by owning pipelines and tankers so that transportation earnings do not get siphoned off to others; and, finally, own sufficient refining and marketing equipment to dispose of your products at cost or better."[1]

In addition, since 1940, the discovery of huge crude reserves has resulted in a world oil glut. Production surpluses, actual and potential, have steadily increased the competitive pressures at the marketing level.

In the last few years, all of the major refiners and the remaining handful of independent refiners have vigorously sought to build or to find market outlets for their surplus products. Mergers, price wars, and expansion by many of the larger companies into new markets have characterized this period. Vigorous antitrust activity by the federal government and the inroads made by natural gas and electricity on fuel oil markets have added further complications.

In short, the basic trend factors are not promising for a small local independent marketer like Henry Fleetwood. Barring some drastic, unpredictable occurrence, it is unlikely that the markets in which Apex Oil operates will improve substantially—at least in the foreseeable future.

## THE ALTERNATIVES

What alternatives does Fleetwood have? The major ones are to (1) stay as he is but try to improve his efficiency; (2) spread into other markets in order to ameliorate the impact of local price wars; (3) seek more price war protection from his or another supplier; or (4) sell his business.

### Improving Efficiency

Almost any businessman can make some gains by improving his financial policies and by carefully reappraising his marketing program. Fleetwood has weakened Apex by making large capital withdrawals. In marketing, he stresses close customer contact, yet he appears unwilling to offer full service. (His policy against grease racks, however, may prove correct in view of sealed-in lubrication systems now being put in new cars.) But even if considerable managerial improvement is possible, it remains doubtful that Fleetwood will be able to offset the adverse long-run external pressures squeezing his profits.

### Penetrating Other Markets

The larger independent retail chains are able to offset some of the effects of price wars by having only a few locations in each market. This policy tends to offset some of the financial advantages of the majors, since the majors will lose more (because they have more stations) in any given local market when prices are depressed. On the other hand, the number of independent chains selling out in recent times implies that even this strategy may not afford a complete solution to the chaotic marketing situation.

The big barrier to any expansion by Apex is the amount of capital it would require. The financial condition of the firm will make borrowing difficult. In addition, Fleetwood is probably already spread about as widely as his small-station, personal-service type of operation will allow. To convert Apex Oil into an effective territorial chain would require a new management organization and substantially enlarged physical facilities.

### Seeking Supplier Aid

The major companies give both their jobbers and dealers various forms of price war protection. Many of the independent refiners have been forced to give their jobber and dealer customers similar aids. Guaranteed margin plans shift at least part of the effect of price wars back on the refiners. Independent refiners operating in many markets may be able to help out in local depressed markets.

Few of the independent refiners, however, have the sizable crude profits (both foreign and domestic) that make it easier for the majors to absorb the price war protection

[1] "Marketing for Humble," *Fortune*, XXI (May, 1940), 83.

plans. If Franklin Oil Refining Company cannot give Fleetwood more price war protection, he should explore the possibility of finding another independent or major supplier. The drawback here is that Fleetwood's stations are ill-suited for conversion into either modern private-brand or major outlets. Some majors, however, will sell gasoline to almost any type of retailer. Perhaps Fleetwood could get margin protection by affiliating as a private brand for a major.

### Selling the Business

Fleetwood should explore thoroughly the alternative of selling his business. It is possible that a tax-free stock deal with Franklin Oil might prove more profitable in the long run than any of the alternatives previously discussed. Franklin Oil has serious problems, but the political and antitrust climate makes it doubtful that things will deteriorate to the point that the Franklin shares would become worthless.

Fleetwood might be able to merge Apex Oil with other local private-brand operators in his same situation. In this way they could dissipate the impact of local price wars. With a larger number of outlets, a better bargain for price protection might be possible.

Until all of these alternatives are explored, no decision can be made. It is clear, however, that the Apex company is in a difficult situation.

## COMMENT *Joseph R. Ewers*

The difficulties faced by the Apex Oil Corporation and, to a certain extent, the Franklin Oil Refining Company are quite typical of many business firms' financial problems.

The deterioration of Apex is obvious from an analysis of the income statement and balance sheet. However, these statements reveal more than the obvious. In many respects, it would appear that Henry Fleetwood has already made his decision; that is, he has been going out of business since 1956. The balance sheet reflects a sharp reduction in the net worth of Apex since 1955. Moreover, this reduction has not been due to the decline in profits, although 1956 and 1959 were not particularly good years. Rather, it is attributable to the substantial withdrawals from the business that Fleetwood has negotiated.

A quick review of the relevant data demonstrates this situation clearly. Net worth has declined from $37,481 at the close of 1955 to $459 at the end of 1959, and during this period profits after taxes totaled nearly $50,000. Total withdrawals from the business of almost $85,000 have weakened considerably Fleetwood's ability to carry on, particularly with the less favorable market developments of the last few years.

These heavy withdrawals have precipitated in large measure the difficult situation Fleetwood now faces. With current liabilities totaling more than $88,000 and current assets valued at slightly more than $50,000 (more than one-third of which is in inventories), he will be pressed to meet his current obligations. Moreover, this condition impairs Fleetwood's ability to negotiate a loan with a bank or other lending sources. It is doubtful that any responsible lending officer would recommend a loan where the manager has obviously stripped the business of its necessary resources, unless rather severe limitations were placed on the firm's operations until the loan is repaid.

Apex's rate of return on total assets before taxes fluctuated as follows: 1955, 30.3 per cent; 1956, 4.0 per cent; 1957, 13.4 per cent; 1958, 26.1 per cent; 1959, 8.7 per cent. All but 1956 and 1959 represent reasonably good years indeed. However, the decline in profitability in 1956 and 1959 must, as much as possible, be anticipated in the financial management of the firm if it is to maintain adequately its long-run profitability and its current financial integrity. The five-year average return on total assets was 16.5 per cent before taxes, which is not too unreasonable under current conditions. (This as-

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sumes, of course, that Fleetwood's salary and any payments to his wife for services have been charged to salaries and wages and not taken out in the form of dividends.) The facts that are available clearly suggest that poor financial management of the Apex Corporation has contributed to the current difficulties as much as, if not more than, the deteriorating market situation in the retail marketing of crude oil products.

Granted that Fleetwood has been the victim of the market as well as of his own personal decisions, what should be his future course? Although the prospects for an ever increasing intensity of competition in the industry seem likely, this alone is no reason to "throw in the towel." Most certainly, the inefficient and sometimes unfortunate are going to drop by the wayside. There is little evidence, however, that an effectively managed independent chain cannot survive, even under the competitive pressures of today. Fleetwood has demonstrated an ability to provide a service on which customers are willing to confer their loyalty. As competition becomes more intense, an effective manager of a small chain must capitalize on his advantages: personal and rapid service, advantageous location, and other unique factors. In some respects, he should be able to respond more quickly to market changes than the larger chain operations whose administrative machinery many times prevents a sensitive reaction to market shifts.

Evidence of this possibility is present in some of the actions Fleetwood has taken in the past. Careful selection of sites, willingness to abandon quickly unprofitable operations, and emphasis on those activities against which the larger concerns cannot easily compete offer some promise. Apex's accounts receivable have more than doubled since 1955, although sales have declined by more than 20 per cent; in the area of credit, there seems to be little to be gained from competing with the majors, whose system of credit cards is a strong competitive weapon. The independent's credit customers are probably those the majors do not want. Moreover, it is costly to carry, process, and collect the receivables.

On the other hand, if Fleetwood's conviction is that the long-run trend in his area is toward increasing competitive pressures and he feels financially inadequate to meet this challenge, then the obvious solution is to negotiate the best possible sales arrangement and to seek other investment and employment opportunities.



When in Moreni [Romania, 1925] we witnessed one of the numerous examples of damage and danger resulting from wells which got out of control in a congested area. The tools had been flung from the hole on striking a virgin deep sand, and the surface fittings damaged, so that oil was being sprayed over a wide area upon buildings, trees and works, and highly inflammable gas pervaded the whole Cricov valley. The gutterings of houses, and the branches of trees were dripping oil. The outflow of 2000 tons a day was being led by gravity into tanks in the Cricov valley. Some days later after tunnelling to the well, a hole was drilled into the side of the casings and a pipe attached, so that mud could be pumped into the well.

—ARTHUR BEEBY-THOMPSON
*Black Gold*

Alfred R. Oxenfeldt and William T. Baxter

# approaches to pricing: ECONOMIST vs ACCOUNTANT



This article examines the part played by the cost accountant in fixing a firm's prices, and especially his assumption that cost plus or full cost is a useful and logical basis for price. It also undertakes the difficult task of reconciling the almost flatly contradictory views of the cost accountant and the economic theorist on pricing.

Generalizations about the two professions must, of course, be unsatisfactory. Since the terms "cost accountant" and "economist" cover many persons with a wide range of views, a short article must omit many desirable qualifications and do injustice to many individuals. However, few who are familiar with both costing and economics would fail to recognize the gulf that often separates the respective approaches to price. It is generally true that the cost accountant fails to state his assumptions about the firm's aims and pays scant attention to demand; he collects cost data and arrives at price by manipulating these. The economist, on the other hand, starts by assuming that the firm is trying to maximize something, for example, profit; he then shows how the firm should study demand as well as cost in an attempt to find this maximum output level.

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## COST PLUS

The cost-plus procedure is too familiar to need extended description.[1] In the multi-product firm, the formula for finding the price of a job runs somewhat as follows: (1) find the job's direct costs—mainly material and labor; (2) add a charge for indirect costs (by allocating these overheads as a rate on a unit such as the wages or hours of direct labor, or machine-hours); and (3) add a further sum for profit—often calculated as a percentage of the total under (1) and (2).

### Objections to Cost Plus

It is not hard to ridicule the logic of the cost-plus doctrine. Its "cost" is objectionable on at least three grounds—time, jointness, and opportunity.

*Time* The avoidable cost of any job depends on the firm's degree of commitment at the time in question. Since this may change with each decision and act, a job has not one cost but a range of costs varying with its stage of completion and at best a cost figure can be right at only one stage. The cost accountant's sums, however, are based on historical records that do not change with changing commitments.

*Jointness* A job is normally a joint product in the sense that other jobs use the same resources. The cost of such resources is thus common to many jobs and there is seldom an unimpeachable basis for dividing it among the jobs (since the resulting figures rarely show what will actually be saved if a given job is not done). Yet full cost includes an allocated slice of common cost.

*Opportunity* Costing tends to concentrate on expenditures of a given work program. It seems to ignore the alternatives open to the enterprise, or to assume that the alternative is idleness. Yet displaced opportunities are vital in making a business decision, which might indeed be defined as the process of selecting among alternatives.

The objections to the "cost" in the cost-plus formula are only part of the problem; economists criticize the "plus," too. The use of a somewhat rigid margin suggests that the firm does not want to find the price levels at which its total profits will be highest—or at least that it is oddly indifferent to the power of demand and of competition. Yet competition in some cases may be strong enough to take price decisions right out of the firm's hands. In other cases, surely the starting point in pricing should be the study of demand (whether, for example, it is elastic or inelastic) and the realization that each possible price may entail a different output and profit.

Superficially, it appears that if a firm adds a margin to costs to cover overheads and profit, it thereby ensures itself some profit. But, of course, this is true only in favorable markets. If cost plus produces a price so high relative to customer valuations that few sales are made, losses will be sustained. No mechanical pricing formula can guarantee a profit, although, unfortunately, cost plus gives the impression of doing so.

### Cost and Displaced Alternatives

Costing thus seems to violate a central cost principle of the economist, that cost can be measured realistically only by taking into account the alternative opportunities open to the firm. To find the sacrifices that will result from the decision to do a job (the economist argues), we must logically look only to the period that still lies in the future at decision date, and must estimate the changes in future expenses and revenues that result from the decision, a procedure

[1]Costing practices are described in countless textbooks. For a description of U.S. pricing practices, see Theodore Karger and C. Clark Thompson, "Pricing Policies and Practices," *Conference Board Business Record,* XIV (September, 1957), 434-42; Joel Dean, *Managerial Economics* (New York: Prentice-Hall, 1951), pp. 444-57; Alfred R. Oxenfeldt, *Industrial Pricing and Market Practices* (New York: Prentice-Hall, 1951), pp. 156-65; and A.D.H. Kaplan, Joel B. Dirlam, and Robert F. Lanzillotti, *Pricing in Big Business* (Washington: The Brookings Institution, 1958).

that obliges us also to estimate what these expenses and revenues would look like if the job is not done.

It will therefore be helpful to classify costs under two heads. The first agrees with what is commonly understood by "cost" (except that it insists on a cause-and-effect relation between decision and sacrifice), while the second differs from the everyday definition of the word in that it is concerned with potential gains displaced by the given job.

*First,* compare expenses if the firm does Job A, with its expenses if it does nothing. In this way, we find the expenses that should appear in an ordinary budget—the sacrifices that the firm can avoid by not doing A or anything in its place. We shall call these potential savings *avoidable costs.*

*Second,* compare the firm's balance sheet after doing Job A with its balance sheet if it instead puts its assets to their next best uses (for example, employs plant on other work, or lends cash at interest). The net revenue that the firm would gain by applying its resources to their next best use is part of the sacrifice of doing A. We shall henceforth use *opportunity cost* in this narrow meaning of net revenue foregone. The total sacrifice involved in doing Job A may thus include both avoidable cost and opportunity cost.[2]

### Business Acceptance of Cost Plus

The objections to cost plus sound formidable in the classroom, but cut remarkably little ice outside. The cost accountant often concedes that they have some validity in private discussion; yet he ignores them in his published writings, and his accounts continue in the main to be filled with historical costs and allocations. These seem to impress executives and to serve as satisfying guides to policy. Cost plus is probably the primary method of fixing price in American industry (and is perhaps even more usual abroad).

The main attraction of cost plus is, of course, that it offers a means by which plausible prices can be found with ease and speed, no matter how many products the firm handles. Moreover, its imposing computations look factual and precise, and its prices may well seem more defensible on moral grounds than prices established by other means. Thus a monopolist, threatened by public inquiry, might reasonably feel that he is safeguarding his case by using cost plus; also when the "just price" of part of a firm's output is at issue (as in contracts for military supplies), cost plus may be the best short-run method of fixing price. For these and other reasons, the appeal of cost plus to harassed executives is plain, even though some of them may look on it privately as no more than an expedient ritual. We must indeed ask whether those of us who are its spoken critics would in fact wholly reject it if we were ourselves responsible for pricing.

The gulf between practice and doctrine is thus extremely wide.[3] In an effort to appraise the issues, we shall now look more

[2] This approach to cost assumes that the cost figures are to be used only for decision on pricing or the like. Some accountants now say that the merits of costing lie more in *control* (of waste, and so on) than in pricing. For control, the right cost may well be historical cost, possibly compared with standard or budget figures.

[3] Considering the size of the gulf, it has excited surprisingly little comment. Costing authors are usually too swamped in massive computations to say what their end-figures mean. Economists tended to ignore costing until the late thirties, when articles by R. H. Coase and R. S. Edwards—republished in David Solomons, ed., *Studies in Costing* (London: Sweet & Maxwell, 1952)—criticized costing theory; and when, for example, R. L. Hall and C. J. Hitch, "Price Theory and Business Behaviour," *Oxford Economic Papers,* No. 2 (May, 1939), pp. 12-45, pointed out that businessmen's descriptions of their own behavior fail to tally with those in economic writings. P.W.S. Andrews in *Manufacturing Business* (London, 1949) went on to suggest that the economist's description is therefore wrong. Such backsliding evoked many retorts, including: Austin Robinson, "Pricing of Manufactured Products," *Economic Journal,* LX (December, 1950), 771-80; and Fritz Machlup, "Marginal Analysis and Empirical Research," *American Economic Review,* XXXVI (September, 1946), 519-54. The virtues and limitations of the economist's approach are ably set out by R. A. Gordon, "Short-Period Price Determination in Theory and Practice," *Studies in Costing,* pp. 183-208.

closely at the cost accountant's figures under various circumstances. We shall, for instance, compare different market structures and contrast single-product with multiproduct firms.

## SINGLE-PRODUCT FIRMS

Where a firm makes only one product, the cost accountant generally summarizes his results as averages. Average cost seems at first sight to serve many useful ends. In particular, it can readily be compared with price and for this reason it is a handy test of whether the firm is earning profits—provided the implied guesses at total cost and volume prove correct. However, average cost becomes less attractive when we distinguish various markets in which the one-product firm may find itself, and consider the pricing problems that these markets sometimes pose.

### Where Markets Are Purely Competitive

Although examples of pure competition are probably not to be found anywhere, rough approximations to the economic theorist's model do exist. Agriculture, organized commodity markets, and some branches of the textile industry come fairly close. In such purely competitive markets, the businessman needs no cost data for pricing purposes. He has no power over price, being compelled to accept the prevailing one, or wait to sell his wares at another time, since price is determined by the interaction of all buyers and sellers, and is not subject to perceptible influence by any one of them. Therefore, cost cannot be the basis for price.

Accounts, however, may still be guides to business policy. Every firm should consider whether it can better itself by altering its scale of operation; the cost accountant would be doing useful work if he drafted budgets of total cost and revenue at various levels of activity. These would show which level is the most profitable, or even that none of the levels is profitable, in which case the firm would do better to switch to other products, or go right out of business. With change in scale comes change in cost; thus, under pure competition, it is price that fixes cost rather than vice versa.

### Where the Product Differs From Competing Products

A firm making a single product that differs from the offerings of rivals generally has some discretion over price.[4] Its price decisions will influence, perhaps strongly, its physical volume of sales. It should presumably try to find the price and volume that bring the highest profit; it may decide to charge a price far below what its rivals ask for competing wares, or to sell at a premium. Only rarely will its best price be the same as its rivals' prices. More important, only rarely and by accident will its most profitable price (in the short run or the long run) be average cost plus a constant conventional margin. Sometimes the firm with the lowest unit costs can command the highest price because of attractive features in its product. To reap the rewards of its skill, such a firm must depart from routine cost plus. As a minimum, it should raise its "plus" when it produces an outstanding product; conversely, when its model is a failure, it may be forced, in order to get rid of the batch, to shift from cost plus to cost minus.

### Where Different Prices Are Charged

Under the two kinds of markets outlined above, we have assumed that the firm sells all units of its one product at the same price. In practice, however, a firm often sells at different prices. The price may be changed rhythmically over time (with seasonal shifts in demand, for instance), or different prices may be charged at the same time in different markets—customers being ostensibly distinguished by location, size of order, or promptness of payment, but in fact by intensity of demand. Many firms believe that

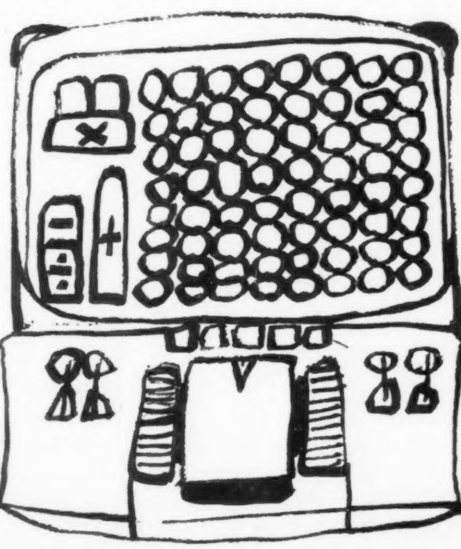
[4]Certain market imperfections have the same result. Firms may, for example, be too widely scattered to experience severe competition.

they raise their profit by varying price in this way; indeed, there seems to be a trend in retailing away from the one-price system and back to old-fashioned higgling.

On occasion, the prices of some units may with advantage be put *below* average cost; as long as sales in the low-priced market exceed the avoidable costs of the extra goods, the firm's net profit is raised. For instance, hotels and airlines sometimes gain by cutting off-peak rates to less than average cost. Comparison of the cut rates with average cost serves little purpose, except perhaps as a clumsy reminder of the deficit to be made good at the peaks.

When one-product firms vary price in such ways, they have presumably rejected cost plus. Here then are cases where our opening statement about the widespread use of cost plus does not apply, and where firms apparently agree with the view that cost plus can impair profit.

For the reasons just given, one might almost say that any reference to average cost will be downright harmful at the pricing stage. Average cost becomes useful after the firm has chosen the best price for the given output program, because comparisons of price and average cost then form a handy miniature budget for predicting period results, and may well suggest a need to change the program. But a miniature budget of this kind cannot give a more accurate financial picture of total revenue and cost than a full budget; in fact, it is likely to be less accurate.



## MULTIPRODUCT FIRMS

The firm with many products is, in its extreme form, the individual job shop that makes unique goods to order—for instance, the engineering shop that bids for special projects. Most common is the firm producing substantial numbers of several standardized products. In such firms, both cost accountant and price fixer are confronted by far harder tasks and, consequently, are all the more apt to take refuge in cost plus.

### Demand Difficulties

As we have said, the economist insists that demand should be consciously weighed when price is being fixed. But the labor and skilled guesswork needed for making detailed demand studies for a wide range of items would generally be prohibitive. Systematic comparison of the firm's prices with those of rivals is perhaps the simplest part of the task, and yet this is often burdensome and confusing. Even the firm that is a price leader might well throw up its hands at the costs of fully estimating demand for each product. Clearly, no firm selling hundreds of products could afford to make careful demand estimates for each; in any case, many of the estimates would be out of date by the time they could be used.

Thus, the accountant has a strong argument in that his system is simple, quick, and cheap. Moreover, and this is a most important point, it lets a manager delegate pricing. Such advantages, coupled with the inevitable vagueness of demand estimates, no doubt go far to explain its wide acceptance.

On the other hand, inability to estimate demand accurately and in time scarcely excuses the substitution of cost information for demand information. Crude estimates of demand might substitute for careful estimates

of demand, but a cost gives remarkably little insight into demand.

## Allocation of Indirect Cost

If asked to explain his charges for indirect costs, the accountant will perhaps explain that a job makes a drain on the firm's manufacturing resources—its plant and space, supervisors, design talent, and the like—and this drain is a cost of the job. Since a big job makes a big drain, cost varies with size.

Here the views of accountant and economist are poles apart. The accountant in effect believes that the total historical cost of providing the plant can be divided up into separate sacrifices for each job. The economist contests the worth of such figures and offers instead his opportunity cost argument: If the firm has excess capacity (plant, supervisors, cash, and so on), *no* sacrifice is involved in using these idle resources on the particular job;[5] if the firm has other uses for the resources, then the cost of assigning them to this job is the sum they would earn (less avoidable costs) in their best alternative uses. Opportunity cost in a range from zero to a large sum is very different from the accountant's layers of overhead.[6]

Overhead allocation is arbitrary in that the choice of any particular basis (for example, direct wages or machine-hours) is hard to justify; in addition, each of the possible bases gives figures that may differ greatly from those found on another basis. Moreover, allocation invests the "fixed costs of the job" with an air of reality that at times deceives some managers, who may, for instance, let plant stand idle rather than use it on jobs that yield less than its full slice of overhead. However onerous—even disastrous—fixed commitments like rent and interest are to the firm, they are not sacrifices for which the individual job is responsible, and are irrelevant in pricing it.

Costs bind the firm, not its customers. In the case of a product, if the avoidable costs exceed its price, the firm can at least stop making it, but where allocations of fixed costs are concerned, this remedy may not help. A firm that cannot turn to more remunerative jobs should carry on with those that fail to cover their share of overhead; such a firm can only hope that the gross margin (revenue minus avoidable cost) on all jobs will meet fixed cost and leave a profit.

## Relevance of the Master Budget

In a firm of any sophistication, job costing (whether in forward-looking budgets or backward-looking accounts) is intimately linked with the firm's plans as stated in its master budget, the budget of total revenue and total cost for the next period. Sometimes such budgets merely give combined figures for the firm's total operations, but generally—if subdivision is feasible—they allow individually for each of the main products. The master budget's projection of revenue implies a specific level of price (hopefully resting on the most competent analysis of market conditions that management can make). Both revenue and cost figures similarly imply forecasts of volume and mix.

From the master budget, with its implicit price and cost per unit, one can derive an average margin per unit. In other words, it is the master budget that gives the rates of allocated overhead and profit for each job. This holds whether the budget is full and formal, or merely a tentative forecast.

If costing and pricing are integrated with a master budget, then several extremely important corollaries seem to follow.

*Pricing Objectives* The master budget presumably states the firm's realistic plans

[5]Any extra expenditure due to the extra wear and tear on equipment and so on *is* a sacrifice caused by the job, and should be included in avoidable cost. This is a good example of the way in which the accountant's direct cost (based on the arbitrary classification of the ledger) can differ from true avoidable cost.

[6]A job's full cost may include, besides the load for factory overhead, a second load for more remote overheads such as administration (usually found as a percentage of the job's direct cost plus the first load). The second is even harder to justify than the first, since a given job is not likely to add much to administrative expense or make much drain on administrative services.

and expectations, and reflects what it is trying to maximize. The economist summarizes the relevant forces in his diagrams of total or marginal cost and revenue, and suggests that the firm will trim its output until it arrives at the point of maximum profit. The master budget seems to be the firm's forecast of its costs and revenue at that point. The maximand may in fact be profit—probably for the long run rather than the budget period alone; more likely, it is some compromise among such advantageous factors as profit, a safe cash position, growth, and prestige.

Considering the importance of the master budget, costing writers are curiously silent about its construction, and add little to our scant understanding of the mental steps behind the big decisions. Their reticence compels the critic to put his own interpretation on this fundamental part of costing theory, but it is doubtful that these writers seriously challenge the economist's view of the firm's aims and methods *at the budget stage.*[7] They must surely regard maximum long-run profit as an important part of the goal—at least in the sense that the less costly method is better than the more costly, and a very low profit is a danger sign.

*Measures of Activity and Size of Job With Diversified Output* Some multiproduct firms have no obvious unit with which to measure the size of jobs. Such firms cannot readily link budget figures with units produced, or speak of unit cost and unit price, nor can they in any direct way compare the profits and costs of different jobs.

We suggest that the one object of job costing is to overcome this difficulty, and to find units where these are not provided by the nature of the job. In a few cases, an artificial unit of output can be devised, such as the "bus mile" or "passenger mile" of a motor bus. Where no common unit of output can be found, the accountant for want of something better may take a unit of input, like wages or hours of direct labor, or machine-hours. The master budget can thus be regarded as a plan for a certain volume of activity measured in man-hours, or some other selected unit. The cost estimate for each job likewise makes use of the same unit for allocating indirect costs and finding price; in this way, cost and price are linked with the job's size.

*Average Cost per Unit With Diversified Output* If this interpretation is right, then the accountant's measure of indirect costs for a job is often akin to an average that is weighted to allow for the job's size, measured in the chosen input units. It has therefore much the same demerits and merits as average cost in the one-product firm. It fails to show the real sacrifice involved in doing the job, but it serves under some circumstances as a miniature forecast of the firm's annual results, and so gives advance warning of a need for revising, say, the scale of operations.

*The Costing Margin as a Processing Charge* Again, just as the one-product budget shows both the number of units to be produced and total revenue, so a multiproduct budget shows planned production in input units and total revenue. But the one-product budget may sensibly deal with unit price whereas to speak of average price per unit in the multiproduct firm usually does not mean much.

If the margin added to direct cost to arrive at price is explained as so much indirect cost and profit per input unit, it has little to recommend it. But if it is regarded as a price per unit—for example, the firm's estimate of the best average price to charge per man-hour for the service of converting

[7]For instance, the concept of profit target as a round percentage on past investment may strike many accountants as no more than a convenient simplification, which can be amended without inconsistency when circumstances demand something less crude. Again, the accountant (like other practical men) sometimes illustrates the master budget with a break-even chart whose lines are straight, in contrast to the economist's curves—thus seeming to imply that output and profit can expand indefinitely. If pressed on the point during discussion, the accountant will freely agree that the implication is absurd; he may explain away the absurdity by saying, for example, that nonmonetary factors, such as strain on management, will in fact check expansion.

direct materials into finished goods—it may be both useful and intellectually defensible. The price quoted for a job could then be regarded as avoidable cost plus a processing charge—with no mention of overhead cost. This idea comes close to the method called "contribution costing," which is used by certain cost accountants when they express the margin on a job as a rate per machine-hour, that is, as the earnings per hour of some key machine that the job utilizes.

A firm in its master budget should presumably try to forecast the number of input units and the average price for each that will give best results. Then, in its day-to-day decisions, it should implement the budget strategy. Suppose, for instance, that the planned costing margin is $\$m$ per man-hour. A job needing $x$ man-hours is priced at $\$mx$ (plus direct costs), not because $\$mx$ measures meaningful slices of overhead, but because this is the price that the firm must charge if it is to carry out its budget decisions. Cost plus, then, represents an administrative trick for putting a price policy into action.

*The Costing Margin and Opportunity Cost* Our interpretation thus implies that a costing margin should be regarded as a tacit allowance for opportunity cost, among other things. The firm first decides that it can maximize profit by selling so many input units of service at a certain price; given this assumption, to do Job X at a lesser rate is to lose greater potential revenue. The loss may arise because X's buyer would in fact be willing to pay more, or because X displaces a better job, or because the firm would need to cut prices all round when X's price became known.

This view, if correct, would go far to explain why costing seems to serve business needs despite its shaky logic. It does not do what it professes to do, but it may do something better; the traditional costing margin —overhead plus profit—may serve as a rough guide to opportunity cost. On the other hand, if costing derives its virtue in this way, then recognition of its true nature would prevent errors based on misinterpretation and would enable accountants to improve their figures.

There are obvious objections to our interpretation of the costing margin, to which we shall return shortly. It does, however, stress one important point; in real life, the alternative to Job X is usually not a known Job Y that neatly duplicates X in everything save profit. The alternative, which may still be unknown when a price is put on X, may consist of several small jobs or part of a large one; it may demand more or less time, space, and money than X. Job-by-job comparisons of profit may, in fact, be impossible or meaningless. Conceivably, operational research will someday help to simplify this issue; in the meantime, probably the best the firm can do is to allow roughly for X's displacement power by means of a load that depends —like the costing margin—on how much of the firm's resources are engaged in the production of X.



## Job Costs and Marginal Analysis

A further conclusion may perhaps follow if the foregoing argument is correct. The conflict between accounting and economics seems, in this area, somewhat unreal; both may simply be dealing with different stages of the production program.

When the economist considers the problem of profit maximization, he is generally thinking of the stage at which the firm is still trying to find its best scale of operation for the next period. He considers, for instance, the results on expected cost and revenue of expanding the next period's ouput from $n$ units to $n + x$ units. ($x$ is here the marginal quantity, and its avoidable cost is the relevant marginal cost.)

Costing is more often concerned with what happens after these plans have been made. As we have seen, estimates for single jobs or small batches assume that the master budget for the period has already been drafted and that the figures of the budget (including planned physical activity of $n$ units, however these are measured) have been used to find rates for burden and profit at the start of the period. Later, at some

point during the period, a given job is considered. Costing tries to estimate inputs of this job, its size ($x$ units), and, thus, its weighted average cost. But the master budget is not changed by the job; output is still expected to total only $n$ (not $n + x$) by the close of the year, for $x$ is merely a part in the planned flow of output. Consequently, the job, its cost, and its revenue do not appear to be marginal in the economist's usual sense; a textbook diagram whose horizontal axis shows total output is helpful for explaining the composite program, but is irrelevant to any job within that program. We suspect that, when economists question businessmen on how the fundamental decisions are made, there may be sad muddling of budget strategy with costing tactics.

### Objections to the Costing Margin

In our attempt to interpret the costing margin as a measure for pricing, we have deliberately passed over the flaws in the argument.

1 One weakness is that the interpretation has never to our knowledge been put forward by a cost accountant.

2 Another lies in the notion of omniscient budgets and clear-cut budget periods; plainly, a costing margin found by a master budget cannot measure opportunity costs at all closely, for the budget assumes such costs to be the same for every date during its period and for all the products. The day-by-day state of the market ought to change a manager's views on the period's possibilities; if he gets a big order, he must, at least mentally, revise his budget totals somewhat. Consequently, a cost margin found at the budget stage may soon be out of date.

3 Again, the argument makes sense only where the firm can in fact switch from one product to another. This is often difficult or impossible, because, for instance, the products emerge in fixed proportions, or plant is built to do only one job. If there is no alternative, there is no opportunity cost.

4 Further, the argument assumes that the chosen input unit correlates with costs and demand in much the same way as the output units of the single-product firm. This is a tall assumption. In some firms, any given input unit seems likely to vary too much with each job's peculiarities to be a good general index of size for all jobs, and there may be no common denominator for size if each job is a distinctive bundle of materials, skills, and services.

5 A customer, to take the demand point of view, will not base his valuations on any internal unit used by his supplier. His test of a job's size is how much he wants it, and his price ceiling is the lower of this subjective value and the price he must pay for a similar article elsewhere, or for substitutes. This composite force on the demand side, and not the supplier's cost and effort, is what enables the supplier to charge more for the big job—and indeed to earn any revenue at all. Accordingly, a prime criterion in choosing a unit should be that it serves as a guide to the bids of rivals; the more their productive methods differ from those of the given firm, the less sound will the latter's input units be as guides.

6 Finally, just as one-product firms may find that it pays to charge different prices in different markets, so the multiproduct firm may benefit by varying its margin per unit on its different products. A firm of jobbing engineers, for example, may make each of its tenders in somewhat different demand conditions; here the case for flexible pricing is very strong.

Although these objections to the use of the costing margin as an indicator of opportunity cost and price are formidable, the pricer in the multiproduct firm must have some measure of the size of each job in order to determine how much of the firm's productive resources (man power, machinery, space, and executive direction) the job will consume. Even when these resources involve no added expense or outlay, they do represent the firm's opportunity to create net income, and some price must be placed on their use if the firm has alternatives. The costing margin may be a crude and imper-

fect tool, and yet be the least objectionable one that is available.

Perhaps the correct attitude toward the costing margin is to regard it in practice as the best starting point for pricing. When the appropriate price for the size of the job has been found by this omnibus formula, management can consider whether the master budget's assumption about the general state of trade still applies or whether demand for the particular article warrants a change in the margin. Considering such factors, they may, perhaps without realizing the extent of their intervention, modify the costing price substantially.[8]

### THE FIRM WITH A "LINE OF PRODUCTS"

A good example of the need to modify prices found by means of a costing margin occurs when a firm sells many different products to the same customer. Such firms may be said to sell a "line of products." A new customer means sales of many products; a lost customer means lost sales of many products.

Cost plus, strictly applied, would often rob the firm of the benefits that come from pricing its wares as a "team" in which some items clear the ground for others. The price line, with the low-price, low-margin items whose function is to "build traffic" and arouse customer interest, and the high-price, high-margin, and high-quality item that brings prestige to the entire line and aids the medium-priced items, is commonplace in many industries. Other firms use the variation of periodically cutting prices of some items for a short time.

Could costing at least show which items to promote and which to drop? There are several difficulties in using accounts to this end. First, the cost side would include some arbitrary allocations; many of the overheads charged to the item under scrutiny would not be reduced to nil by dropping it. Second, the revenues are likely to understate the item's contributions; inclusion of an item in the line may well explain how important customers have been won and held. Finally, the decision maker must look to the item's future rather than its past.

Accordingly, this kind of firm is likely to be led astray—both in fixing prices and in deciding whether to promote, drop, or maintain items—if it relies on traditional accounts. It is far better for an expert price fixer to guess clumsily at the right factors than to measure precisely those that are irrelevant. He should estimate the demand for those products that are unique in some degree and arrange prices on the team principle; when he is considering whether to drop an item, he should guess at what it adds to revenue by boosting the sale of other products. The mechanical application of a generalized budget formula is here most unlikely to measure opportunity costs. A cost estimate of the savings from dropping the item may be useful, but it should be an *ad hoc* estimate, confined to costs that will in fact be changed by the omission.

## SUGGESTED PROCEDURE

Early in this article, we posed two problems. Why is cost plus so popular, despite its crude logic? And, would we, if we were in positions of business responsibility, reject this approach? We shall now try to answer both questions by outlining the way in which we think the cost accountant should help with pricing.

### FORMULA VS. INDIVIDUAL ANALYSIS

The central problem is whether any general formula, such as cost plus, suitably reinterpreted, can with advantage be put in the place of individual decisions about each price.

The two main factors to be weighed by a pricer are demand and cost. Demand should ideally be studied with the utmost care by persons of outstanding discernment. We believe that no formula can accurately assess all the pulls and shifts of the living market, and that management must in the end bear

[8]I. F. Pearce showed in "A Study in Price Policy," *Economica*, XXIII (May, 1956), 114-27 that in one firm, whose managers firmly believed they worked on cost plus, job prices found by cost plus became actual prices in only a minority of cases.

full responsibility for estimating demand. A formula can be defended only on the grounds that careful judgments on each separate price are either not feasible (because of the need for quick decisions on many articles) or not worth while (because of the high risk of error). The retail shop provides an apt analogy: its owner might well maximize profit by bargaining afresh with each customer on each visit over each unit of stock, but in practice he is usually forced by the difficulties of doing otherwise to put the same price ticket on all like units.

Cost may at first sight seem easier to reduce to a formula. If, however, it is looked on as a choice between alternatives, it too becomes subjective and hard to weigh. Ideally, a job's cost should be estimated by senior managers after full consideration of the likely alternatives and all their impacts on future possibilities. We accept that no formula will do justice to a host of dimly foreseen and hypothetical events, and that management must shoulder the task of choosing between alternatives. But a formula may still be defensible, if only on the grounds that it winnows out the obviously unattractive plans, and leaves managers free to work on plans that offer a good prospect of success.

In short, the formula can be defended only as a last resort. Our task is to consider the circumstances in which it is most likely to be a useful supplement to special studies, and the means by which its defects can be minimized.

### Building the Master Budget

As we have seen, the formula implies the existence of some sort of forecast—at its best, a full budget of the firm's revenue and costs. Such a budget seems desirable in any case. Before it is drafted, certain basic questions might well be explicitly posed. Is it the firm's aim to win maximum profit, at least in the long run and with various provisos? Is there a point on the firm's scale of activity at which profit is maximized, and on either side of which profit declines through the combined action of cost and demand forces? Practical men will know that such questions cannot be answered without qualifications, and that no one can pinpoint the quantities at stake. The important thing is to be clear on the objective and plan of attack.

Demand and price should play a big part in the plan. Our discussion has stressed the major influence of demand, and how this varies in different markets. In some markets, the firm has no discretionary power over price; the only major decision concerns scale of output. In others, the firm must simultaneously envisage price, demand, volume, and cost as interrelated parts of the budget problem.

In firms facing several types of demand, or making several products with very different cost patterns, the budget should be split up between home and foreign markets, or time of year, or type of product, and so forth. The firm must study demand in each market, and try to map out the best price policy in each; it must also draft separate budgets for each department that has a fairly uniform cost pattern.

### The Task of the Formula

The budget establishes the general plan—scale, level of prices, and so on. The formula tries to put this plan into effect when the minor decisions are later made on each job.

One must in each case ask whether the firm can foresee the future clearly enough to establish such an all-embracing plan. If conditions change so fast that even supplementary budgets soon lag behind events, then a predetermined formula seems likely to do mischief. The same holds if the various jobs differ greatly, whether on the side of demand or costs. The formula presumably assumes stability and sameness in day-to-day operations; it relies on "what things usually cost" or "what we can usually charge," and thus breaks down if there is no "usual."

For reasons set out earlier, we cannot accept the normal wording of the formula in terms of allocated overhead, and so on. We prefer to interpret it as a measure of contribution, that is, what the firm believes to be its best price, per unit of activity, for converting direct inputs into finished goods.

If the formula is to work well, it must allow for three quantities that would otherwise need to be found by special estimate:

1 Concealed and remote avoidable costs

2 Opportunity costs, that is, the contribution to overhead and the profit that could be obtained by doing other jobs instead

3 Any further contribution from this particular job.

The formula's claims may be tested by following the build-up of a price, step by step; we shall, if we do not state the contrary, deal with single jobs rather than large flows.

*Building a Price* The first step is to find the avoidable costs. Though the direct costs of the accountant may often be very similar to the obvious avoidable costs, the accountant's figures are based on clerical convenience rather than a cause-and-effect relationship between decision and sacrifice.[9] They will thus on occasion need amending in two ways: The money values attached to some ingredients must be changed, for example, by substituting current for historical cost; and the list of direct costs must be extended to include those avoidable costs that accounting classes as indirect. By their very nature, items on this extended list may be hard to detect and evaluate; even a special study for the job might end with a very vague guess at the sums in question. Therefore, it does not seem unreasonable to allow for them roughly with a rate per unit of size, unless the job has individual peculiarities that call for a special estimate. Size in this context seems more likely to be a function of time (man-hours or machine-hours) than of direct expenses.

If we ignore odd cases like the loss-leader, avoidable cost will be the lowest price at which the firm will ever take on work. This minimum will, however, need to be raised if the given job displaces other profitable opportunities. Accordingly, the next step is to estimate opportunity cost.

*Opportunity Cost* The alternatives to the given job may be known and clearly measurable. If they are, straightforward comparison between the job and the best alternative should be easy, and will show which work yields the biggest margin. If they are not, then a margin based on normal yields per unit of activity seems likely to be helpful, at least as a starting point. However, since such a margin cannot be more correct than the master budget from which it springs, the pricer should consider whether the budget still holds good. There may be a temporary change in activity, or new trends may be emerging, in the light of which the load for the given job should be trimmed. Unless the margin rate keeps pace with the order book, it is a poor guide to opportunity cost.

Which unit of activity from contenders such as direct labor cost or machine-hours should the formula employ to measure opportunity cost? Presumably the firm must find out by experience which unit best satisfies a double test: (1) prices based on this unit must attract the desired volume of activity; and yet (2) the items bought at these prices must not displace more remunerative items. The right unit is thus part of the price mechanism that equates demand with supply; customer reactions to the unit are important as well as the firm's internal workings. When one starts to find out whether a given job will displace other work, one's first inclination is perhaps to look for any scarce factor that acts as a bottleneck in production. Such a factor may exist; if, for example, labor is short, man-hours may be a good index of displaced jobs. Under imperfect competition, however, a firm may have plenty of "slack" in a physical sense, and yet continue to charge a margin. Here the bottleneck is not physical; it is the firm's own policy of restricting sales volume by keeping up prices. In this case, therefore, one should not search for bottlenecks in the plant, but should use the unit that rations sales most

[9] For instance, a clerk can trace the historical cost of raw materials through his records from their purchase until they enter the final product, but the resulting "direct cost" may not show the sacrifice due to the decision to use materials in stock. This decision probably causes the purchase of new materials; if so, the sacrifice is not a figure already in the books, but the outlay on replacement.

profitably (particularly in markets that are subject to destructive price cutting). Once again, a unit based on time seems most likely to work well; but, conceivably, the best unit for measuring opportunity cost is not the best for measuring concealed avoidable cost.

*Profit Margin* When the pricer has estimated the job's avoidable and opportunity costs, his next and final step is to ask how much more can be added as pure profit.

In many cases, the ceiling is obvious—the price charged by rivals (adjusted to allow for any special features in the firm's own product). If this is less than total cost, the firm will withdraw from the race. If it is more, the pricer must judge how near it to pitch his figure, a calculation for which direct comparison would seem a better guide than the formula.

But, where the product is new or a tender has to be made for a special job, the firm may not yet know the competing prices. Here one of the chief aims of the cost department might be to guess the prices charged by rivals. If the latter rely on a formula, then a formula may be a useful tool for predicting their prices; indeed, the normal full-cost estimate may be defensible on the grounds that it suggests not the firm's own costs, but the prices of competitors (actual or potential). Presumably the formula should not be used blindly, but should be adapted in the light of what is known of the rival's ways. For instance, a special estimate might be needed if the rival has a different method of production.

There may be a wide space between the cost floor and the demand ceiling. In that case, bargaining skill rather than economic factors may fix the position of price, or the firm may gain by charging a low price, perhaps because this will mean many future sales. An omnibus formula can scarcely respond to situations of this type. Nor can it weigh the eagerness of particular customers or the merits of a particular product. Such factors strengthen the case for using individual decisions to modify the formula's figure for profit.

*Cost and Price for Large Batches* Our approach must obviously be modified when we pass from the individual job to many sales of like units. Here the pricer faces nearly all the complexities of the complete budget in a single-product firm: cost may vary with volume, which may vary with the price that he is trying to find. No mechanical approach that relies on the use of a formula can do justice to such a problem.

The accountant can help by providing cost estimates at several points of the scale of output; the pricer must try to guess demand at corresponding points, and so find the optimum scale of operations. As the drafting of many precise estimates would involve much work, there may be good reason for using a formula in the preliminary stages. When the choice has been narrowed, special studies of avoidable and opportunity cost may become worth while, particularly if the given batch of new articles is big enough to suggest that it amounts to a change in the master budget.

*Importance of Demand* Our review of the forces at stake has emphasized the supreme importance of demand. Though this force is hard to gauge, the pricer's success must in the long run depend on his flair for assessing it.

Part of his problem stems from the effect that frequent price changes may have in the long run on customer relations. He should be equipped with a clear statement of the firm's policy on this point. Does the firm feel that isolated price concessions will involve a serious handicap in the future? The top executive might even be called upon to set a figure that measures the size of the handicap; for instance, he might estimate that price stability would in the long run justify a drop in current profits of up to $25,000.

The pricer may sometimes get helpful impressions from other members of the firm. If, for example, he is trying to set prices for a line and to employ the team-pricing concept, men in the sales department are likely to be the best source of information about which items to treat as promotional numbers, how much to charge for a prestige model, and the

probable gain in general sales from having a particular item in the line.

The pricer should gather data and impressions from others within the firm, including data from specific studies specially undertaken for him by the market research department. In the end, however, he must size up all the relevant forces for himself. He cannot move directly from cost to price; he cannot even assign clear values to many of the forces. He can probably do his job best by drawing up a schedule covering the main factors at stake, and by making his own estimate, however crude, of their values. Such schedules would call for different information according to the type of product and market. Once prepared, however, they would be helpful starting points the next time a price decision for the same product was needed.

In the procedures described above, costs are still important, and it is to be hoped that the cost accountant will help to make the estimates. Since he is the man most at home with the firm's cost structure, he can give much useful information.

However, if the cost accountant is to play his full part, he must adopt an approach that is still alien to his tradition; any attempt to kill two birds with one stone (that is, to use his ledger balances for pricing as well as for their more fitting task of control) will fail. He must abandon a classification that depends on clerical traceability; he must look forward rather than back, and must cease to imagine he can perform the miracle of splitting common cost. Further, he must recognize the need for a wider range of information, much of it subjective; opportunity cost depends on factors about which the accountant in many firms is at present not kept informed, such as the nature of the market and the state of the order book. Thus, he must keep in close touch with other departments, notably the sales department.

Such a task would be an exacting challenge to the cost accountant. But it would make for much closer ties between him and the managers, since he would have to be privy to their intentions and alternative plans, and, in consequence, it would greatly enhance his status.

OUR APPROACH can in part be summarized as a plea for cost statements with more precise words and less precise figures. The words ought to serve as clear explanations of the different kinds of sacrifice—obvious avoidable costs, hidden avoidable costs, and opportunity costs. Many cost figures must inevitably be guesswork, and this should be made plain; on occasion, they will be none the worse for being expressed as a range of probabilities, or for being sprinkled with question marks. Such vagueness accords with the facts of business life better than a facade of precision.

Clear words would also show the nature of each computation, whether it is the passive product of a formula, or a special estimate. A pricer must choose between the two. The special estimate is plainly superior in the sense of being more logical and flexible; but, as none of us has boundless wisdom, time, and energy, there may often be a sound case for the critical use of a formula.

Jules Backman and Harry Sauvain

# THE PROBLEM OF SIZE IN COMMERCIAL BANKING



Headlines announcing bank mergers, actions taken by the U.S. Department of Justice to prevent their consummation, and attacks on bigness per se imply that concentration of banks is increasing rapidly in this country. It is true that some changes are taking place, as is both inevitable and desirable in a dynamic society. But viewed in historical perspective, these changes are surprisingly small and often quite different from those suggested in the headlines.

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Since the end of the war and particularly in the past decade, the extension of branch banking, bank mergers, and to some extent the development of bank holding companies have brought about important changes in the organizational structure of commercial banks. The force behind these changes has been the tremendous pressures of competition, both among banks and between banks and other types of financial institutions, to provide better financial services and to do so more economically. But, strange as it may seem, these changes in organizational structure are being vigorously challenged by opponents of concentration in banking, and particularly by the Department of Justice, on the grounds that they "tend to lessen competition." The manner in which the courts, and eventually the Congress, settle

this conflict will have a strong influence upon the quality and cost of banking services to business, to individuals, and even to government itself for many years to come.

None of the developments bringing about this change in the structure of commercial banking is really new. Branch banking has existed since the early years of our nation. The first and second Banks of the United States, chartered by the federal government, were branch-banking institutions. In the nineteenth century some state-chartered banks operated branch offices, and in 1900 commercial banks had about 100 branch offices. Banks have been merging from time to time since our nation was founded. The first bank holding company was organized in 1900 and a number of banking groups were in operation by 1920. What is new is the acceleration in the rate of development of branch banking and in the prominence of the banks involved in some mergers in recent years.



## NEW DEVELOPMENTS

### BRANCH BANKING

Until shortly after World War I, the number of commercial banks increased very rapidly; the peak was reached in 1921 when this country had more than 30,000 commercial banks. Since branch banking was still unimportant, the total number of banking offices was only slightly larger. There is now general agreement that the country was "overbanked" at that time. An FDIC study found that "By 1920 there were thirteen States with less than 2,500 people per bank, all of them in the Great Plains and Rocky Mountains areas. The State with the lowest figure was North Dakota, with a bank for every 720 persons."[1]

From the end of 1940 to the end of 1960 the number of banks in the United States declined from 14,534 to 13,472, but over the same period the number of banking offices increased from 18,065 to 23,688. The explanation for the 13 per cent increase in number of banking offices in the face of a decline in number of banks is to be found, of course, in the rapid growth of branch banking. There were almost three times as many branch offices at the end of the twenty-year period as at the beginning. Moreover, the rate of growth in number of branch offices has increased. In the ten years ending 1960, the number of branch offices more than doubled, as compared with a moderate increase in the preceding ten-year period. Data on number of banks, branches, and total banking offices are given in Table 1.

TABLE 1

**Number of Commercial Banks and Branches, Selected Years, 1921-60**

| | Number of Commercial Banks | Number of Branches | Total Offices |
|---|---|---|---|
| 1921 | 30,456 | 1,455 | 31,911 |
| 1929 | 24,970 | 3,353 | 28,323 |
| 1934 | 15,348 | 3,007 | 18,355 |
| 1940 | 14,534 | 3,531 | 18,065 |
| 1950 | 14,146 | 4,721 | 18,867 |
| 1960 | 13,472 | 10,216 | 23,688 |

SOURCE: U.S. Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1957* (Washington: U.S. Gov't Printing Office, 1960), pp. 631, 635, and *Federal Reserve Bulletin* (April, 1961), pp. 486-87.

For the most part, the growth in number of branch offices has resulted from the opening of new branch offices by established commercial banks rather than from the merging of smaller banks and larger banks with the smaller banks becoming branch offices. Excluding discontinued offices, about three *de novo* branches were opened for each one acquired by merger in the period from 1934 through 1959. The data from which this relationship was established include private banks and mutual savings banks, but the totals for these institutions are small and do not significantly affect the generalization.[2]

The magnitude of the increase in number of branches has varied widely by states. Naturally the largest increases have devel-

[1] *Annual Report of the Federal Deposit Insurance Corporation for the Year Ended December 31, 1960* (Washington: U.S. Gov't Printing Office, 1961), p. 40 (hereafter referred to as *FDIC 1960 Annual Report*).

[2] *FDIC 1960 Annual Report*, p. 33.

TABLE 2

**Banks Absorbed by Merger in the United States**

| Year | Number | Year | Number |
|---|---|---|---|
| 1950 | 89 | 1955 | 321 |
| 1951 | 79 | 1956 | 189 |
| 1952 | 99 | 1957 | 161 |
| 1953 | 115 | 1958 | 152 |
| 1954 | 207 | 1959 | 169 |
| **Total** | | | **1,491** |

SOURCE: *FDIC 1960 Annual Report*, p. 33.

oped in the states permitting state-wide branch banking or branch banking subject to restrictions of geographical area within the state. In recent years a number of states have enlarged the areas within which branches are permitted, and a few have abolished laws prohibiting branch banking. The development of branch banking has been most pronounced in California, North Carolina, South Carolina, Maryland, Arizona, and Rhode Island.[3]

### MERGERS

Newspaper reports of bank mergers, particularly of those involving the larger banks in major urban centers, give a somewhat exaggerated impression of the importance of mergers in the evaluation of the commercial banking structure. According to the FDIC, 1,491 banks were absorbed during the 1950's. This was about 10 per cent of the total number of banks at the beginning of the decade. Over the same period, 876 new banks began operations (not including a few reopenings of suspended banks). It must be recognized that the absorbed banks usually were larger than the newly organized institutions. The net decrease in the number of banks during the 1950's, therefore, was only about 4 per cent.[4] For the country as a whole there has been no very distinct tendency for the number of bank mergers to increase during recent years, as shown in Table 2.

The trend toward bank mergers, however, has varied considerably among the different states. Generally, it has been most pronounced in the states that permit branch banking, either state-wide or within fairly large areas. The trend has also been apparent in the larger cities and frequently has involved large banks whose names are well known.

In the longer period from 1934 to 1958, for which FDIC data are available, there was a decline of more than 50 per cent in the number of banks in Arizona, California, Idaho, and Washington. The percentage decline was in the range of about 40 to 50 per cent in Delaware, the District of Columbia, Nevada, New York, Oregon, and Rhode Island. The states in both categories are those where state-wide branch banking, or limited area branch banking, is prevalent. On the other hand, a few states have experienced an increase in number of banks, notably, Florida and Illinois, where branch banking is prohibited, and Louisiana, New Mexico, and South Carolina, where there is limited area branch banking. It is clear that both mergers and *de novo* branches have increased concentrations in states with the less rigid restrictions on branch banking, although the policies of state banking authorities in chartering new banks also have some influence on the number of banks.

### BANK HOLDING COMPANIES

A bank holding company, in general terms, is a company that owns at least 25 per cent of the voting stock of two or more banks. The banks controlled by a bank holding company are usually known as a "group," and such an affiliation is commonly known as group banking.

According to Nadler and Bogen, "The period of most rapid development of bank holding companies was the latter half of the decade of the 1920's, when many of the na-

[3] State-wide branch banking is prevalent in fourteen states, with locational restrictions in some instances; in sixteen states and the District of Columbia, limited area branch banking is prevalent; in other states, unit banking prevails even though limited branch banking is permitted in some instances. See *FDIC 1960 Annual Report*, p. 45.

[4] *FDIC 1960 Annual Report*, p. 33.

tion's leading bank groups were organized."[5] At the end of 1931 there were 97 bank groups, but the depression years took a heavy toll and by 1936 there were 52 groups controlling 3.2 per cent of all the commercial banks in the country that held 14 per cent of all the deposits. The number continued to decline until in 1945 there were only 33 groups and they accounted for only 12 per cent of total bank deposits. In the postwar period, however, this trend in number of groups was reversed. By the end of 1960 there were 47 bank holding companies controlling 426 banks and operating 1,463 banking offices in 31 states. However, these bank groups represented only 6.2 per cent of the total number of banking offices and 8.0 per cent of total commercial bank deposits in the United States.[6]

The largest holding companies in October, 1961 were Western Bancorporation, Marine Midland Corporation, Northwest Bancorporation, and First Bank Stock Corporation. Western Bancorporation, the largest bank holding company, operates in eleven western states; at the end of 1960 its subsidiaries had deposits of $4.7 billion. The second largest, Marine Midland Corporation, operates solely in New York State; at the end of 1960 it had deposits of $2.3 billion. The third largest holding company, Northwest Bancorporation, has its head office in Minneapolis with banks and branches in Minnesota, Iowa, Nebraska, Montana, Wisconsin, North Dakota, and South Dakota; at the end of 1960, its subsidiaries held deposits of $1.8 billion. The First Bank Stock Corporation also has its main office in Minneapolis. It operates in Minnesota, Montana, Wisconsin, North Dakota, and South Dakota; on December 31, 1960 its subsidiaries held deposits of $1.7 billion.

Group banking has some unique features. The individual banks comprising a group usually retain a high degree of autonomy. The stock held by the holding company is usually voted by proxy by the local management. Directors, with some exceptions, are local citizens nominated by the local management. Some bank holding companies review the nominees for directorships, but apparently any differences with local management are settled informally. Sometimes directors or senior officers of holding companies are members of the boards of principal affiliated banks, but in other instances none of the management personnel of holding companies serves as a director of an affiliated bank. Since the board of directors of a bank, once elected, has full authority and responsibility for the bank's management during their term of office, bank holding companies cannot legally exercise a veto power over actions of the directors of an affiliated bank during that period.

Along with the relative autonomy of group banks, there is usually a very considerable degree both of cooperation and rivalry. Frequently there are "group committees," composed of representatives from several or all of the banks in a group, whose job it is to work on common problems. Sometimes one member bank of a group tries out innovations in banking and shares its experience with the other members. The holding company usually offers important technical services to the members of its group. Thus a considerable degree of decentralization of management is obtained along with coordination, cooperation, and technical aids. This system is said to stimulate the managements of local banks in a group to compete with each other to show better operating results.

## THE MOTIVATIONS FOR CHANGE

Many bankers believe that they can provide better banking service by creating larger banking organizations, thus realizing the economies of a larger scale of operation. "Economies of size" mean to them not only reductions in cost of operations, but also improvement in the quality of banking services to the public, the ability to offer a wider range of services, and even the opportunity

[5] Marcus Nadler and Jules I. Bogen, *The Bank Holding Company* (New York: New York University Graduate School of Business Administration, 1959), p. 10.

[6] *Federal Reserve Bulletin*, XLVII (June, 1961), 722.

to realize a more rapid rate of innovation in the entire area of commercial banking.

### Increased Demand

The development of branch banking, for example, is to some extent a response to the existence of an "underbanked" situation in the 1930's. Some communities were left without adequate banking facilities, and the establishment of branches was designed to fill the void. The very considerable growth in the size of the economy and in both the size and geographical distribution of the population also has created a need for branch bank offices where previously none existed. One factor has been the development of suburban shopping centers with need for banking facilities. Within cities, banks have established new branch offices and drive-in windows for the convenience of their customers. All these developments come under the heading of providing more extensive banking services.

### Operating Economies

The growth in size of most banking organizations has provided opportunities for economies in virtually all of the complex phases of banking operations. Perhaps most conspicuous at the moment is the opportunity to reduce costs and improve service by the use of electronic data processing equipment. The economies of size also include better recruiting and training of personnel, which is urgently needed in banking today; improvement in pension funds and other fringe benefits for employees; reductions in cost of printing and supplies through larger volume of purchases; the ability of larger organizations to raise additional capital by sale of stock on better terms than those obtainable by smaller banks; and the development of sufficient volume to put on a profitable basis some services that have often been rendered at a loss.

### Improvement in Services

Even more impressive is the opportunity afforded by increase in size to improve the quality of banking service. A small country bank can do little more for its customers than hold deposits, make some loans, and provide checking account service. It can provide some additional services through the facilities of correspondent banks. A larger bank, or banking organization, can do a great deal more. It can provide better installment loan service by developing special types of consumer installment loans, as well as specialized personnel to handle this kind of business. It can provide better commercial loan service by being able to make individual loans of larger size, by having a sufficiently large staff of loan officers so that some can specialize in loans to companies in particular industries, and by developing particular types of loans such as term loans and loans to finance purchase of business equipment. It can provide better trust service by operating one or more common trust funds, by having specialists in estate planning, and by having the volume of business necessary to support a staff of investment specialists.

Banks that are able to operate over a large geographical area can provide uniform service to business firms carrying on operations at different locations within the area. The larger banks can offer, especially to large commercial customers, well-developed facilities for managing pension and profit-sharing plans. In some instances, a bank of larger size has the ability to offer better foreign department service to firms that carry on international business.

Even the state and local governments benefit from the economies of size in that only the larger banks are able to operate fully developed municipal bond departments for underwriting and distributing their security issues and, incidentally, to provide much needed technical advice in setting up the terms and conditions of new municipal issues. The short-term credit needs of state and local governments may also be met more conveniently and economically by banks of larger size.

Strong arguments for permitting multiple-office banking by branch or holding company methods are advanced in a recent study by two faculty members of the Graduate School of Business, University of Chicago, working

under a grant from the Chicago Association of Commerce and Industry. These authors point out that,

> "Permitting branch and holding company operations does not make it compulsory. It simply makes it possible for all types of business organizations to compete freely for the public favor. If the independent operations have advantages, it will retain them. The public can choose."[7]

Another recent study makes a close comparison of the economic impact of state-wide branch banking on Arizona with the effect of limited branch banking in neighboring New Mexico. The study concludes that state-wide branch banking has been more beneficial to economic development.[8]

## LEGISLATION

The American people are often emotional and sentimental about the way the banking business is run in this country. They like "home-town" banks; they fear the "money monopoly" of some vague power called "Wall Street," and some people still mistrust banks altogether. It is not difficult, therefore, to frighten the electorate with the alleged evils of some change in the banking structure. It is probably on this account that some legislators and government officials, sensitive to the feelings of their constituents, have watched the recent spread of branch banking, the bank mergers, and the development of group banking with suspicion and even with alarm.

### BRANCH BANKING

Branch banking long has been regulated by the states. The National Banking Act of 1863 said nothing about national banks' having branch offices. The Federal Reserve Act of 1913 permitted state banks operating branches under state laws to become member banks. Not until 1922 did the Comptroller of the Currency, by administrative ruling, permit limited branching by national banks, and not until 1952 were national banks permitted the full latitude in establishing branches that was allowed to state-chartered banks. In effect, then, the rules for branch banking by national banks are made by the several states.

Federal legislation has provided for approval of branches of national banks by the Comptroller of the Currency, of those of state member banks of the Federal Reserve System by the Board of Governors, and of branches of state-insured banks that are not members of the Federal Reserve System by the Federal Deposit Insurance Corporation.

### MERGERS

In the field of bank mergers the principal federal legislation, until recently, was the Sherman Act of 1890, which prohibits monopoly and combinations in restraint of trade, and the Clayton Act of 1914, which prohibits the acquisition of the stock of one company by another whenever the effect may be to lessen competition substantially, or to tend to create a monopoly. The Clayton Act vests authority to enforce compliance as far as banks are concerned in the Board of Governors of the Federal Reserve System. Under the provisions of this act, the Board of Governors brought suit against the Transamerica Corporation in 1953 on the ground that it was tending to create a monopoly by acquisition of banks in a five-state area. The Board lost the suit. In 1959 the Department of Justice took legal action under the antitrust laws to block the acquisition of the California Bank by the Firstamerica Corporation. This suit was settled by a compromise arrangement that created two banking organizations to compete with the huge Bank of America.

In 1960, the Congress endeavored to settle the matter of federal control over bank mergers by passing the Bank Merger Act as an amendment to the Federal Deposit Insur-

[7] Irving Schweiger and John S. McGee, *Chicago Banking* (Chicago: Graduate School of Business, University of Chicago, 1961).

[8] Paul D. Butt, *Branch Banking and Economic Growth in Arizona and New Mexico* (Albuquerque: Bureau of Business Research, University of New Mexico, 1960).

ance Corporation Act. The Bank Merger Act provides that no insured bank shall merge or consolidate with any other insured bank, or acquire assets of any other bank, unless prior approval is obtained from the Comptroller of the Currency if it is a national bank, from the Board of Governors of the Federal Reserve System if it is a state member bank, or from the FDIC if it is an insured nonmember bank. In acting on applications, the authority concerned must consider: (1) financial history and condition of each of the banks involved; (2) adequacy of capital structure of the bank to be created by merger; (3) future earnings prospects; (4) general character of its management; (5) convenience and need of the community; (6) consistency of its corporate powers with the purposes of the act; (7) effects on competition; and (8) the public interest.

Unless immediate action is necessary to prevent failure of one of the banks, the approving authority must request the U.S. Attorney General to submit, within 30 days, a report on the competitive factors involved. The report of the Attorney General is *not* binding on the banking authorities, and it apparently was the intention of Congress to leave final decisions in the hands of the three federal bank regulatory agencies.

In the decisions that have been made under the Bank Merger Act, it appears that the federal regulatory agencies have given very careful attention to the effects of bank mergers upon competition. They have also been concerned with the convenience and needs of the community and the public interest. But recently the whole matter of federal regulation of bank mergers has taken a new turn; the Attorney General has filed suits under the antitrust laws for injunctions against mergers that *have been approved* by the federal bank supervisory authorities under the Bank Merger Act.

In February, 1961, in spite of the objections of the Attorney General, the Comptroller of the Currency approved a merger between the Philadelphia National Bank and The Girard Trust Co. and a merger between two banks in Lexington, Kentucky. Thereupon, the Department of Justice filed antitrust suits to prevent the consummation of both mergers on the grounds that they were anticompetitive. In September, 1961, the Department of Justice instituted an antitrust suit after the Federal Reserve Board had approved the merger of the Manufacturers Trust Company and Hanover Bank of New York. It also sued to prevent the merger of the Continental Illinois National Bank & Trust Company and the City National Bank & Trust Company in Chicago after that merger had been approved by the Comptroller of the Currency.

Thus we have the anomalous situation of two federal bank supervisory agencies approving bank mergers under the Bank Merger Act and another agency of the federal government, the Department of Justice, opposing these decisions under the antitrust laws. These proceedings raise the question of whether the federal bank supervisory authorities really have the power apparently granted to them by Congress, or whether the Department of Justice and the courts will decide the legality of bank mergers. At the present time the question has not been clearly answered by court rulings.

### Bank Holding Companies

Federal regulation of bank holding companies started with the Banking Act of 1933, which provided that holding companies could vote the stock of their bank subsidiaries that are members of the Federal Reserve System only after being granted a voting permit by the Board of Governors. In the process of considering applications for voting permits, the Board was directed, among other things, to consider the effect upon competition. This legislation also required that all national banks must obtain three reports annually from their holding company affiliates and submit them to the Comptroller of the Currency.

In 1956 Congress set up an entirely new system of control by enacting the Bank Holding Company Act. This law makes it illegal for any bank holding company to acquire bank stocks, or take certain other actions, without prior approval of the Board of Governors of the Federal Reserve System.

At that time, all bank holding companies were required to register with the Board and to divest themselves of interests in nonbanking organizations within two years. The act also prohibits loans by subsidiary banks of a bank holding company to the holding company or to other subsidiaries.

Section 3(c) of the Holding Company Act requires the Board to take into consideration the following five factors in acting on applications for acquisition of bank stocks by holding companies: "(1) the financial history and condition of the holding companies and bank concerned; (2) their prospects; (3) the character of their management; (4) the convenience, needs, and welfare of the communities and the area concerned; and (5) whether or not the effect of the acquisition would be to expand the size or extent of the bank holding company system involved beyond limits consistent with adequate and sound banking, the public interest, and the preservation of competition in the field of banking."[9]



Three types of applications have been made to the Federal Reserve Board: (1) for approval of establishment of holding companies; (2) for establishment of *de novo* banks by holding companies; and (3) for the acquisition of other banks by holding companies. All of the statutory factors must be considered in connection with each type of proposal. The first three factors usually involve no special problem, nor are they dominant in the final decision. A typical conclusion in a Board decision denying an application is the following:

"The financial history and condition, the prospects, and the management of both [The] Marine [Corporation] and [The Wisconsin State] Bank appear to be satisfactory. With respect to these factors, The Board [of Governors] finds no substantial grounds for either approval or disapproval of the application."[10]

The Board appears to have given more weight to convenience, needs, and welfare in connection with the establishment of *de novo* banks by holding companies than it did in its decisions concerning the formation of new holding companies and the acquisition of existing banks by holding companies. Wherever possible, the Board has preferred to have needs met by a newly established independent bank. The availability of this alternative was noted in relation to the denial of three applications, while the future foreclosure of a new independent bank was cited in the fourth denial.

In connection with the acquisition of banks, only minor attention is given to the fourth statutory factor, namely, convenience, needs, and welfare, although frequently it is concluded that some improvement in banking service would result. Thus, in the First National Bank of Pipestone decision the Board said, " . . . it is recognized that Northwest's acquisition of control might result in some expansion of Bank's services and facilities. However, these facts do not, in the Board's judgment, provide strong ground in themselves for approval of the application, since Bank already is adequately contributing toward fulfilling the needs of its community for banking services."[11]

The decisive factor appears to be the anticipated competitive effects. In this connection the Board usually reviews the existing proportions of deposits of the affected banks in their banking areas, the extent to which there is an overlapping of business between the holding company's present subsidiaries and the proposed acquisition, the remaining alternative sources of service, and related factors designed to indicate the impact of the acquisition on competition. Many of these decisions appear to emphasize the quantitative rather than the qualitative aspects of competition.[12]

[9] *Federal Reserve Bulletin,* XLVII (August, 1961), 918.

[10] *In the Matter of the Application of the Marine Corporation for prior approval of acquisition of voting shares of Wisconsin State Bank, Milwaukee, Wisconsin,* June 29, 1961, *Federal Reserve Bulletin,* XLVII (July, 1961), 764. The Board subsequently approved this acquisition. See *Federal Reserve Bulletin,* XLVII (October, 1961), 1179-82.

[11] *Federal Reserve Bulletin,* XLVII (April, 1961), 409.

[12] Governor J. L. Robertson has stated that the "real purpose" of the Bank Holding Company Act is "to regulate the expansion of bank holding companies so as to prevent undue concentration of control of banking resources by such companies." *Federal Reserve Bulletin,* XLVII (July, 1961), 762.

Between 1956 and 1960, the Board rejected only four applications made by holding companies and approved twenty-eight. In the first nine months of 1961, however, it denied four out of eleven applications. This may be an indication that recently greater weight has been given to the competition factor, or that more severe tests are being applied, although the evidence on this point is not yet clear.

The Department of Justice, nevertheless, is not completely satisfied with the decisions of the Federal Reserve Board. In March, 1961, after the Board had approved the acquisition of a Milwaukee bank by the Bank Stock Corporation (a holding company), the Department of Justice brought an antitrust action to prevent the acquisition. Thus there appears again the dichotomy of one federal government agency's approval of a banking combination, and another agency's opposition to it.

## MEASURING COMPETITION

In their studies of the probable effects of bank mergers and the formation or extension of bank holding companies upon competition, the federal bank supervisory agencies and the Department of Justice have relied heavily upon concentration ratios. They calculate the proportion of bank assets or bank deposits that would be held by a merged bank in its banking area, or the proportion that would be held by a holding company (or a holding company bank) in its area. There seems to be a marked tendency to conclude that if the ratio is "too high"—a level never specifically indicated—or if the resultant bank is the largest in the area, the proposed banking combination would tend substantially to lessen competition. This is an altogether too simple and mechanistic way of measuring the effect upon competition.


Concentration ratios have more limited meaning and are surrounded with many more reservations for banking than for manufacturing or other forms of nonfinancial activity. The commercial banks are providers of a wide variety of financial services to a wide variety of individuals, business enterprises, and government units. This range of service makes the measurement of concentration more difficult. Professor Jules I. Bogen of New York University has pointed out: "Because of the great diversity of services provided by the banks, there is no practical single measure of the volume of services rendered comparable to unit sales of a manufacturing industry."[13] Conceivably, concentration ratios could be developed for different types of banking service, such as commercial loans, installment loans, savings deposits, demand deposits, and trust services, but little use has been made of this kind of analysis.

Concentration in banking on a national scale has not increased in the past two decades, according to the FDIC. Data published by this agency are presented in Table 3. The extent to which deposits were concentrated in the largest banks in this country was significantly lower in 1960 than it was twenty years earlier. The hundred largest banks accounted for 46.2 per cent of deposits in 1960 as compared with 56.7 per cent in 1940. The

[13] Jules I. Bogen, *The Adequacy of Bank Earnings* (New York: New York University Graduate School of Business Administration, 1958), p. 7.

entire decline occurred during the 1940's, however, and from 1949 to 1960 the concentration increased 1.7 percentage points. A similar pattern is shown for the ten largest banks.[14] The largest banks have experienced diverse trends, with the western banks tending to increase in relative importance and the New York City banks to decline in importance. The composite data for the ten largest and one hundred largest banks conceal these offsetting changes.

The data by states are available for December 31, 1940 and December 31, 1958. Here a mixed pattern is found. In eleven of the fourteen states with *state-wide branch banking*, the percentage of deposits accounted for by the five largest commercial banks increased between these dates. But in eleven out of sixteen states with *limited area branch banking* and in sixteen out of eighteen states with *unit banking*, the proportion accounted for by the "big five" declined.

Data are not available for the metropolitan areas for 1940, but they are for December 31, 1934. Table 3 shows that for the largest banks the national concentration was greater in 1940 than in 1934 so that the comparisons noted below are undoubtedly affected by the dates for which data are available. In nine out of thirty-one metropolitan areas with limited area branch banking, the percentage of deposits held by the big five declined between 1934 and 1958. The ratio also declined for sixteen out of seventeen areas in which unit banking was prevalent.

It is evident that the concentration trends have varied widely throughout the country. While the ratios have declined in more than half the states and metropolitan areas, there has been a tendency for concentration of deposits to rise in areas where branch banking has developed. With few exceptions, the ratios have declined in areas that are largely limited to unit banking.



[14] The FDIC also prepared data for the largest commercial banks *and* bank groups for 1940 and 1958. The magnitude of decline between 1940 and 1958 was similar to that shown for commercial banks alone. The share accounted for by the one hundred largest declined from 59.4 per cent in 1940 to 49.1 per cent in 1958; for the ten largest the decline was from 26.9 per cent to 20.7 per cent.

**TABLE 3**

**Percentage of Total Deposits in Largest Commercial Banks, Selected Years, 1920-60**

| | Largest Bank | 10 Largest Banks | 100 Largest Banks |
|---|---|---|---|
| 1920 | 1.9 | 9.7 | * |
| 1929 | 2.6 | 16.4 | 41.9 |
| 1934 | 4.1 | 22.9 | 53.6 |
| 1940 | 5.3 | 26.4 | 56.7 |
| 1949 | 3.9 | 18.9 | 44.5 |
| 1958 | 4.6 | 19.9 | 45.7 |
| 1960 | 4.5 | 20.3 | 46.2 |

* Not available.

Source: *FDIC 1960 Annual Report*, pp. 51, 100.

There are two important factors that especially limit the significance of concentration in commercial banking: (1) the comprehensive system of bank regulation, and (2) the growth of nonbank institutions, which provide many services that compete with banking services. In smaller communities high concentration is unavoidable because only one or two banks can be supported and the regulatory agencies will not approve additional banks or branches.[15] Such concentration as prevails in commercial banking reflects in part the results of regulatory actions, and any interpretation of the meaning of these ratios must allow for the influence of these decisions. In this connection, J. L. Robertson, a member of the Board of Governors of the Federal Reserve System, has stated:

". . . one must remember that banks are in a little different category than other commercial institutions in that they are pretty much of a quasi-public institution, they are granted almost a monopoly at the time they are chartered."[16]

[15] As of June 30, 1958, 7,703 commercial banks were in small communities with one banking office and 3,412 were in communities with only two offices. Practically all of the one-bank towns had a population of less than 5,000, while only a few of the two-bank towns had a population in excess of 25,000. (See *FDIC 1960 Annual Report*, pp. 47-48.)

[16] *Current Antitrust Problems*, Hearings before Antitrust Subcommittee (Subcommittee No. 5) of the House Committee on the Judiciary, 84th Cong., 1st sess. (Washington: U.S. Gov't Printing Office, 1955), p. 2175.

### Nonbank Institutions

Of even greater importance has been the growing competition from mutual savings banks, savings and loan associations, credit unions, insurance companies, personal finance companies, and other financial institutions. One careful student has pointed out that "Effective substitutes for commercial bank loans could render concentration ratios meaningless in terms of alternative sources . . . ."[17]

Other financial institutions compete particularly for savings and for making installment loans and mortgage loans. Thus, for example, on December 31, 1960, the commercial banks accounted for only 18.3 per cent of the total mortgage loans in the nation and had a smaller share of the total than did savings and loan associations (38.1 per cent) and life insurance companies (26.5 per cent).[18] If allowance is made for the mortgages held by government agencies and individuals, these ratios would be even smaller. Similarly, commercial banks accounted for 37.9 per cent of the installment credit outstanding on December 31, 1960; sales finance companies with 25.6 per cent were the second largest source of such funds.[19]

Although the bank supervisory authorities have given considerable weight to concentration ratios in connection with mergers and the formation of holding companies, they have also recognized that competition from other institutions can be important for some types of services.[20] The Federal Reserve Board has specifically recognized the role of the savings banks.

The real question, of course, is not degree of concentration but the extent of competition. Several studies of New York State's experience have indicated that mergers have not inhibited competition and even that smaller independent banks often have grown more rapidly than the larger banks. The extent to which the smaller banks outgrew the large ones in New York City between 1940 and 1960 has been summarized as follows:

> "The twenty domestic commercial banks in New York which had assets of less than $50 million each in 1940 have grown by 444% over the past 20 years—a growth rate about four times greater than that of the New York Clearing House banks."[21]

This greater rate of growth was achieved despite the increase in the share accounted for by the five largest banks, part of which reflected mergers.[22]

The increase in relative importance of the small independent bank seems surprising at first glance, but it reflects two developments. First, the surviving independent banks are often the best managed; their leadership is vigorous and imaginative. They are resourceful banks in terms of taking advantage of competitive opportunities. Second, they operate in the areas of greatest growth in banking, namely, retail banking. Consumer credit, mortgage loans, special checking accounts, and related services have been the expanding areas in banking. Small independent banks operate largely in these areas and thus have experienced the beneficial effects of a strong growth trend.

From this discussion of changes in the banking structure and in banking legislation, it can be concluded that in the future

[17] David A. Alhadeff, *Monopoly and Competition in Banking* (Berkeley: University of California Press, 1954), pp. 39-40.

[18] *Federal Reserve Bulletin,* XLVII (April, 1961), 434, 442, 454.

[19] *Federal Reserve Bulletin,* XLVII (February, 1961), 206.

[20] The New York State Banking Department has noted that " . . . in many of the services affected by commercial banks (i.e., lending of money, accepting thrift deposits, affording custodial services, trusteeships, etc.) there is a high degree of service . . . interchangeability. . . ." Memorandum of the Superintendent of Banks, State of New York, an Application of Chemical Corn Exchange Bank and the New York Trust for approval of merger, September 9, 1959, pp. 41-42.

[21] Memorandum on Proposed Merger Submitted to The Comptroller of the Currency on May 15, 1961 by First National City Bank and National Bank of Westchester.

[22] See also *Chicago Banking,* pp. 28-31. In Milwaukee County, Wisconsin, the independent banks held 30 per cent of the deposits of individuals, partnerships, and corporations at December 31, 1959 as compared with 24 per cent for the same banks ten years earlier. *Federal Reserve Bulletin,* XLVII (July, 1961), 765.

important questions of public policy will be raised concerning our commercial banking system. Decisions made over the next year or two will influence the nature of our banking structure and the quality of banking service for a long time to come.

We want effective competition among banks and between banks and other kinds of financial institutions. This is an essential part of our private enterprise system. We must recognize, moreover, that competition is not reduced when we depart from some idealized concept of "smallness." The business community and many individuals want better and more economical banking services. Certainly the growth of our national economy requires that adequate credit resources be readily available both to business and individuals. As our economy grows and living standards further improve, there will be an increased need for the more specialized trust and investment management functions of commercial banks. To meet these needs larger banks are required.

The real question is the extent of competition, not the degree of concentration. We must find improved methods for measuring the effects of expansion of branch banking, bank mergers, and the development of bank groups upon competition. These better ways must recognize that banks sell a variety of banking services, that they sell them in competition not only with other banks but also with several other types of institutions that provide similar or alternative financial services, and that the geographical scope of the markets for different services of any one bank may vary considerably.

One of the most urgent problems of public policy in banking is to decide what laws shall govern banking combinations and what agency of the federal government shall have authority to administer the laws. The present confused situation is intolerable from the public point of view. On this question the authors strongly believe that the federal bank supervisory agencies staffed by men who know banking and who, in most instances, have devoted much of their lives to bank supervision are far more competent to appraise the effects of banking combinations upon banking competition than the lawyers in the Department of Justice.



YET THE math class should be the richest territory in school. Words are magic, yes—but they are black magic, there is a disturbing aura about the word, it means too much. Numbers are white magic, recreation, the gymnastics of the mind. Words sing, but numbers dance. And every child can see them dance: society places no screens in his way. Social class status, home atmosphere, cultural influence, the great complex of attitudes and skills each child learns out of school—all these elements, casting their inescapable shadow everywhere else in the curriculum, may be kept out of the mathematics class.

—*Martin Mayer*
THE SCHOOLS

Walter P. Blass

# HOW SMALL BUSINESS CAN SUCCEED ABROAD



Although interest in foreign operations has been growing rapidly in the past few years, there is surprisingly little information available regarding small business investments. Larger firms such as pharmaceutical houses, automobile manufacturers, and petroleum distributors have staffs with considerable foreign experience and can program substantial funds for field studies and research. Should the enterprise fail in spite of precautions, they can use the tax write-off provisions of the law to lessen the impact of such losses on other profits. The smaller businessman must of necessity make a decision on the basis of fewer facts, less experience, and less of a cushion in case of business reverses. On the other hand, he has several advantages over the larger investor that may serve to make his venture more profitable.

This article is intended to fill the gap—to provide American "small" and "medium" businessmen who might invest in the less developed countries with some guidelines that will aid in establishing a framework for a proper decision. For purposes of definition, we may characterize such businessmen as those willing and able, in terms of their domestic corporate structure, to invest up to $500,000 abroad.

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A sound point of departure for such a decision is the motivation that leads the investor to look overseas for new business. Does the domestic labor situation seem too rigid? Is the firm finding it hard to adapt itself to the changing requirements of the market? Do American tax laws seem too complex or discriminatory? From the point of view of starting a business in the underdeveloped parts of the world, none of these reasons is very sound. Almost all of these countries have labor laws providing for job security and working conditions far beyond the dreams of the AFL-CIO. The markets are inchoate in form, channels of distribution are unsuited to rapid promotion or change, and customers cannot effectively communicate their wants. Tax laws are antiquated in most cases and not conducive to business expansion. If these factors make business life at home difficult, there is no incentive to exchange such problems for worse ones overseas.

Are there too many firms in the industry? Do possibilities for innovation and development of the product seem limited? Is the challenge of fifty years ago somehow absent from present business conditions? An affirmative answer to these latter questions provides the businessman with a clue to what he can expect in the way of positive values in setting up an overseas firm. Most countries in Asia and Africa have no concept of merchandising or retailing as such – the words do not exist in the local language. The idea of changing a product to suit the customer's changing needs is a novel one there. Competition is restricted, generally because no one cares to provide any. Investment for a growing market has not been contemplated, and the atmosphere is one of dividing up a pie of fixed size. Still, many American businessmen who travel the circuit between Tokyo and Tripoli are awestruck by the opportunities for creative private enterprise—not gigantic mills or vast mines, but job shops, small factories, and supermarkets and laundromats, all of them business enterprises that abound in any U.S. community of more than 50,000 population. While it is evident that there can be no proper statistical measure of such opportunities, a reasonable indication is given by the growth of investment in such countries in the fields of manufacturing and trade. Table 1 shows the extent of such developments in three underdeveloped continents.

TABLE 1

**Direct U.S. Investments by Area, 1929-59**
***(in millions of dollars)***

| Manufacturers | Latin America | Africa | Asia |
|---|---|---|---|
| 1929 | 231 | 7 | 76 |
| 1950 | 781 | 35 | 60 |
| 1959 | 1,426 | 120 | 248 |
| **Trade** | | | |
| 1929 | 119 | 16 | 34 |
| 1950 | 245 | 24 | 49 |
| 1959 | 687 | 45 | 114 |

SOURCE: U. S. Department of Commerce.

Another way of evaluating such investments may be to look at some particular examples. One venture that has succeeded is the Pilot Pen Company (India) Ltd., organized in 1952 to produce ink and fountain pens. It uses both the trade name and the technical production methods of the highly successful Japanese parent firm. Shares totaling $100,000 (in Indian currency) were issued, 30 per cent of these were subscribed to by the Japanese and the remainder by local capital. The company now has over two hundred employees, attained a return of over 30 per cent on the initial capital in four years, and expects to double its plant investment shortly.

A leading industrialist and financier in India, K. Lalbhai, served as the entrepreneur and provider of initial capital in developing the dye stuff and chemical industry in India. After contacting American Cyanamid and obtaining a 10 per cent investment, he set up Atul Products Ltd. to produce dye stuffs and pharmaceuticals. He acquired ownership in Cyanamid's distributor and used the existing trade channels of the latter to distribute the new company's products. Several years later he made similar agreements with two of the major chemical houses, CIBA (Swiss) and ICI (British). The company started with a $2 million invest-

ment; now it has shares outstanding of $10 million—mostly held by Indians—and is returning a profit of 8 per cent per share after 25 per cent of the profits are retained for depreciation and internal financing.[1]

Neither of these ventures involved great capital investment, particularly on the part of the foreign investor, yet both were highly successful because novel techniques were employed to improve a desirable product for which a market already existed. They are particularly interesting in that they offer some sidelights on the usual fears that foreigners have about sinking capital funds in seemingly high-risk countries. The case of the fountain pen company shows that a domestic company has expanded with only a small injection of foreign capital, most of it in the form of specialized machines and managerial assistance for improving quality and merchandising. Such a firm cannot be expropriated since it is largely a domestic enterprise. It is not likely to be nationalized for its prestige value or "bigness." But its products will probably cut down imports of similar foreign goods and thus appear favorably on India's foreign exchange books. The remittance of profits is likely to be considered by the government as a valuable premium to be paid for the net gain in foreign exchange as well as the expansion of business volume. Furthermore, had the investing firm been American, it could have insured itself against expropriation, risk of war, and convertibility of repatriated capital and profits with the U.S. government under the corresponding legislation.

## THE GUIDELINES

What then are the guidelines by which the smaller businessmen can be helped to invest in an underdeveloped country? We may, with advantage, select four general areas of approach: information, organization, financing, and the investment climate. This list by no means exhausts all of the necessary considerations, nor are the four areas covered as fully as they could be; they are, however, vital considerations and they supplement the more commonly known ones.

### Information

*Sources* The small businessman should attempt to gather all possible information about investment in the particular country that interests him. A start can be made by consulting a Department of Commerce publication entitled "Investment in . . . "; this is available for more than seventeen countries. Other sources include banks with branches in the country, commercial attachés of the country at its embassy in the United States, and specialized libraries in the trade associations such as the American Iron and Steel Institute. The Bureau of Foreign Commerce maintains offices in the larger U. S. cities, which also have libraries of considerable scope.

A source of substantial knowledge in this field is likely to be the businessman or Commerce Department official who went as a member of an Investment Development team sponsored jointly by the Departments of Commerce and State. These teams of three to five men—the majority of them businessmen, armed with voluminous trade directories—go for several weeks to a given country for the purpose of selling American business abroad and speaking with business leaders, Chambers of Commerce, government officials, and trade groups. Such men are likely to have some highly specific suggestions and cautions about investment in the area they have studied. Reports of these teams and names of members are generally available from the Bureau of Foreign Commerce in Washington, and notice is given of terminal conferences held by the members in the department publication, *Foreign Commerce Weekly*. When all the domestic sources have been exhausted, the investor should consider a personal inspection trip. A $2,000 investment here may save many times its value in mistakes or may point out

[1] M. V. Pylee, "Joint International Business Ventures in India," unpublished pamphlet (May, 1959), pp. 125, 178. Material from this pamphlet incorporated into W. Friedman, *Joint International Business Ventures* (New York: Columbia University Press, 1959).

areas of greater potential. Personal contacts developed on such an exploratory visit are the beginning of a sound investment.

*Market Analysis* Analysis of the market is the next step. Proper understanding of what sells and why is the key to successful investment here and abroad. In underdeveloped countries, resistance to change may be great, but the expansion of a sure-fire seller is not likely to result in losses.

Two contrasting examples will illustrate how essential this step is. In Ghana, a small investment group hired a professional market research expert with local experience to determine the possibilities of selling packaged talcum powder through the "mammy trader" system in the interior. The market was assessed favorably, and the enterprise subsequently flourished. In Nigeria, a pencil manufacturer from one of the European countries asked the local bank to determine whether a sufficient market existed for an overseas plant of "minimum" size, that is, 40 million pencils annually. An unfavorable report in this instance prevented a possibly serious loss to this manufacturer.



### Organization

*Partnership* The small businessman should not go it alone; preferably, he should seek partnership with an already successful local businessman. The days are over when the name of England, America, or France or one of its prominent firms was magic to the natives. Now the emphasis is on firms that identify themselves with the host country, on hiring fixed percentages of "host country nationals," and on the use of names and titles in the native language. It may be useful to boast of licenses from foreign firms, but the president is likely to be better received if the color of his face is familiar locally. On the practical side, the knowledge of distribution, of reliable suppliers and fabricators, of dealing with the local labor market is likely to be greater among successful local businessmen than among foreigners. This does not mean that the business acumen of local minorities, which in some countries constitute the leading business groups, has to go

TABLE 2

**Minority Ownership Abroad**

| | Proportion of Investments of Less than 50 Per Cent to All Investments | | |
|---|---|---|---|
| | Latin America | Africa | Asia |
| Established before 1946 | 5% | 3% | 3% |
| Established 1951-57 | 11% | 7% | 12% |

Source: U. S. Department of Commerce.

untapped. In India the Parsees and Tatas, in West Africa the Syrians and Lebanese, and in the Congo the Portuguese control much of the commerce in their respective regions. Rather, this warning is intended to prevent the setting up of an American enterprise staffed by Americans.

*Minority Holdings* Unorthodox forms of enterprise are worthy of investigation. There is no rule that investments must be made in the standard 51-49 per cent corporate form. Some countries will not permit greater ownership by the foreign investor; frequently, a sizable minority interest is more acceptable all around. Table 2 illustrates a small but increasing trend toward this form of minority holding in U. S. foreign investment.

Control may be exercised in a number of ways—through the selection of key officials, licensing agreements, or the supply of key raw materials, to name but a few. The supply of materials was the means of control chosen by the German combine DEMAG when it assisted in the financing of the first integrated iron and steel mill built at Helwan, Egypt in 1958. The profitable experience of the scrap furnace and rerolling mill production of the period 1935-55 encouraged Egyptian capital to put up most of the necessary funds for construction and equipment. The combine put up the remainder on the condition that it be the supplier of most of the machinery and all of the coke to be consumed by the new works.

The International Basic Economy Corporation, a creation of the Rockefeller family, uses many methods of control over its

extensive investments in twenty-one different projects in Latin America. Its services include organizing manufacturing companies, negotiating licensing agreements, surveying markets, bringing together potential partners, assisting in arranging financing, and guiding in administration. It operates through fees, commissions, or shares in the equity of foreign operations that it organizes or serves. These shareholdings may range from 100 per cent to only 7 per cent. The IBEC has helped in forming agricultural processing plants for coffee, seeds, and poultry feed, shopping centers, and a metal working plant. It has even gone into the broader area of investment banking and management companies.

Some firms, notably German firms that have recently made overtures in Egypt, have agreed to investments where the fixed plant and machinery will revert to domestic ownership after a fixed period, and capital and profits will come out of current production. Such an arrangement may sound far more beneficial to the host country than the more orthodox concepts of ownership. Yet any investor can understand with a little thought how such an arrangement can be quite rewarding, given normal depreciation practices and tax laws.

## Financing

*Local Sources* It is important to learn what sources of financing are available besides personal investment. This rather obvious consideration is largely neglected by foreign investors who are thinking of starting a business in an underdeveloped country. As pointed out earlier, expanding a going local enterprise may be the best approach, but even if an entirely new business is started—such as a laundromat—local capital should play a prominent if not dominant role. There is a shibboleth accepted by American and local officials alike that the supply of capital it stretched to the limit by current enterprise and ambitious plans for the future. Offered as proof of this statement is the high rate of interest in local banks and other financial institutions.

Yet careful observation of profitable ventures shows that ". . . in a real sense and within certain important limits . . . a sufficiently strong demand for capital may create its own supply of savings."[2] Another observer found that "in many underdeveloped countries, including India, the amount of capital available for investment is often surprisingly and inexplicably large."[3] That adequate local sources of investment are often available was amply demonstrated by events in two entirely different countries. In Ceylon, when the Ford Motor Company decided to discontinue its distribution of spare parts and operate instead through a locally owned outlet, a local businessman found that shares he tried to sell in a company to take over the service were accepted rapidly. He was able to float the entire issue the first day, and then had to turn away prospective buyers. Similar eagerness on the part of local investors was experienced in Nigeria. Barclay's Bank D.C.O. recently assisted in the launching of a share issue of the Nigerian Cement Company Ltd. (a concern financed jointly by Nigerian and United Kingdom public funds and two British companies) that was oversubscribed. Of the total applications, 51 per cent were for the minimum number of ten shares, and 95 per cent of the applications for these shares were from Africans.

*Government-Sponsored Sources* Private capital and local financing are not the only possible sources of business capital. Many governments have established national Development Banks to expand business opportunities and capital. An example of this kind of establishment is the Industrial Credit and Investment Corporation of India Ltd. (ICICI). It has underwritten public and private issues of shares and offers of sale of industrial securities and made direct subscriptions to such securities. It has made secured loans in rupees payable over periods

[2] Charles Wolf, Jr. and Sidney C. Suffrin, *Capital Formation and Foreign Investment in Underdeveloped Areas* (Syracuse: Syracuse University Press, 1958), p. 15.

[3] William Diamond, *Development Banks* (Baltimore: The Johns Hopkins Press, 1957), p. 10.

up to fifteen years, extended similar loans in foreign currency for payment of imported capital equipment and technical services, and guaranteed payments for credits made by others. In addition to strictly monetary help, it has announced it is ready to assist clients in the preparation of investment proposals, and to make available or find technical and managerial advice and services both in India and abroad.[4]

A recent development has been the availability of local currency from the proceeds of the sale of surplus U. S. agricultural commodities (PL 480[e]). This Cooley amendment capital can be obtained through the Export-Import Bank in Washington. It is lent at prevailing rates of interest with the agreement of the government of the country. A sizable amount has accrued in many countries, such as Ceylon, Pakistan, India, Korea, and Viet Nam, to mention only Asian countries. It has, moreover, been scarcely utilized in these countries and others because American firms or their subsidiaries, the only legally eligible borrowers, have not significantly taken advantage of the provisions of the amendment. Loaned at normal rates, such capital is comparatively easy to obtain and may represent a useful additional method of financing.

*Insurance* The small overseas investor should get the maximum benefit of existing insurance coverage available in his chosen country. The Investment Guaranty Program of the International Cooperation Administration is one such form of insurance. It covers the investor against a number of nonbusiness risks in a given country—expropriation, war risk, or convertibility. These vary according to treaties in force, but, once issued, they are sound protection for the period involved—usually one year and renewable. The coverage costs comparatively little (.5 per cent per contract year for each of the three types) and removes the greatest elements of nonbusiness risk. Added coverage for insurrection and revolution, moreover, has been written into the law in 1961.

In addition, the Development Loan Fund and the Export-Import Bank write insurance policies. Both borrowers and nonborrowers may avail themselves of these. The DLF insurance is similar to the Investment Guaranty Program except that it covers foreign firms as well as American companies and subsidiaries and can be issued for countries where no treaty is yet in force. Export-Import Bank insurance is available for U. S. exports, including those on consignment awaiting sale. The latter would be a considerable help to a supplier who sets up a foreign operation but whose largest investment will lie in the monthly shipments of raw materials to run the plant.

*Banks* Finally, the role of the bank with an interest or branch in the country should not be neglected. Businessmen have long valued the shrewd business counsel of experienced bankers, and in many of these countries there are banks with experience dating back to the turn of the century. Not only are they equipped to advise clients on local laws and the prevailing climate for investment, but they are well informed on local capital markets, names of prominent and successful businessmen, and sources of reliable credit information. Some banks have become a meeting ground of foreign investors and local businessmen. The latter seek to benefit from the advanced technology and capital resources available through the bank's clients in Europe and America; the clients, in their turn, seek new markets and fields for investment. It is not surprising that, in the case of the British, banks in India and Africa have long been consulted by home office clients for accurate information on credit worthiness and business prospects.

Some American banks in the Philippines have developed, in response to their clients' needs, detailed and accurate import statistics that would otherwise be unavailable. In many countries, however, banks (American banks, in particular) are not doing as much as they could to provide this kind of information. This is partly because of lack of

[4] *The ICICI: A Source of Capital for Private Industry in India* (Bombay: The Commercial Printing Press Private Ltd., 1959).

interest and knowledge on the part of investors, partly because of an insufficient realization of the benefits that can accrue to the banks themselves through these types of services. American banks have comparatively few branches in Asia and Africa compared to the British and French financial institutions. Yet banking techniques developed in the United States are singularly applicable there. Installment plan buying and the financing of industrial growth through financial intermediaries such as the CIT Corporation, factoring institutions, and the like are only gradually spreading to the underdeveloped countries. A few American banks are generating new investment by participating in the equity financing of new foreign companies through their Edge Act subsidiaries; notable instances are Chase International Investment Corporation and First National City Bank's International Banking Corporation. Chase, for example, has been a major source of financing in several sizable projects including a new steel mill in Turkey and an industrial development bank in Iran.

### Investment Climate

The small businessman should invest to meet the market's needs for a product or service, not merely to make a quick profit. It is significant that those who have had outstanding successes in foreign enterprises —large or small—have understood their market, generated business activity, and satisfied the host country's desire for employment, income, and growth. These activities have turned out to be profitable as well, but as Lyndall F. Urwick has said: "Profit can be no more the objective of a business than betting is the objective of racing, making a score the objective of cricket, or eating is the objective of living."[5] Host governments want the investment of capital but are highly suspicious of exploitation. In Nigeria, for example, those firms exercising "a dominating influence over the people's livelihood" were threatened with nationalization. Where jobs are created, business activity burgeons, and factories and houses go up, few governments are likely to kill the goose that laid those eggs.

Where poverty is not alleviated, where each year's balance of payments shows a large deficit because of profit repatriation and no corresponding inflow of investment capital, where the host country's people learn little about technical jobs or the management of enterprise, governments, regardless of whether they are revolutionary or only mildly socialist, feel a strong pressure toward restrictive steps or confiscation. The difference between the treatment of oil companies by Iran and by the neighboring Middle Eastern countries was due in large part to the 50-50 split provisions for royalties and the considerable social consciousness of the American oil companies.[6] In extractive industries such as rubber and copper, the comparatively good labor relations of American companies in South America and Africa have caused these companies to be regarded as partners in progress rather than ripe plums to be picked.

The investor should not neglect the possibility that is open to him to create or change the climate of investment. Many underdeveloped countries are in the process of writing an investment law, frequently with little experience and too often with a lack of representation by interested businessmen. Knowledge of what has worked well in inducing business investment is not common among these governments; yet business has not done much to publicize the kinds of existing investment laws it considers workable or even to model investment laws or charters.

Moreover, at home, although businessmen here are extremely vocal and well represented by lobby groups in Washington, the field of foreign investment has not received its share of attention. Programs for tax incentives, amendment of the present

[5] Lyndall F. Urwick, *The Elements of Administration* (New York: Harper & Brothers, 1943), p. 27.

[6] See Carleton S. Coon, "Operation Bultiste: Industrial Development in Saudi Arabia," in Howard M. Teaf, Jr. and Peter G. Franck, eds., *Hands Across Frontiers: Case Studies in Technical Cooperation* (Ithaca: Cornell University Press, 1955).

Edge Act to permit greater flexibility, exemption of branch banks from double taxation, and the passing of insurable risks to private enterprise have lain untouched in government pigeonholes for years. They have been neglected in large measure because too little support was given these proposals by the fellow businessmen of August Maffry of Irving Trust, Ralph Strauss of R. H. Macy, and many others who drafted such suggestions. Representative Hale Boggs' bill in the House, which provided for the creation of a Foreign Business Corporation with special tax status, has been stalled in committee when it could have been the beginning of a highly important period in American private investment overseas. Few banks, moreover, testified in its favor and too few businessmen spoke up for it. Such an attitude comes at a time when private enterprise is increasingly pressed throughout the world to prove its value against government enterprise. It should not be said of American business that it failed in this task because it did not care enough to exercise its latent powers.



In the foregoing analysis we have explored several specific guidelines that can serve the smaller American investor in underdeveloped countries. While the list has not been exhaustive, and could not be in such limited space, they may be used as a supplement to the ordinary and better known procedures and cautions.

Four areas have been briefly surveyed:

What information does the investor need about the country and market in which he is interested?

What types of organization should he employ?

What sources of financing are available and desirable besides his own capital?

What contribution can the investor make toward creating his own investment climate?

Where sources are available for consultation and help in answering these questions, they have been indicated. The amount of detail sought by investors will, of course, vary with their needs. A listing of these guidelines cannot be a prescription for success in business investment in underdeveloped countries; they will not prove to be a formula that will magically open doors to profits. Cumbersome local legislation, complex currency exchanges, discriminatory tax laws, and the myriad difficulties of working with people less used to technology and change will be encountered in spite of any assistance. Businessmen, however, have faced up to these challenges before, and the incentives to do so are still there.

Things are no longer what they were twenty years ago. Buying and selling here is more profitable than sending many wares to Portugal. German merchandise has no market here and is useless for this country. Writing tables split in the great heat; clockwork, or anything else made of iron, deteriorates at sea. This year there is nothing to send to Portugal, for pepper, ginger, maces, cocoa-nut fat have all been brought for the contractors, also cinnamon for the King. One really does not know at this time in what to invest one's money.

*—Letter from Cochin in India, Jan. 10, 1580*
News and Rumor in Renaissance Europe
(The Fugger Newsletters)

William H. Peterson

# The Case Against Antimerger Policy



In dismissing in December, 1960, the government's suit to break up the four-year-old merger of the Continental Can Company and the Hazel-Atlas Glass Company, Federal Judge Frederick Van Pelt Bryan said the evidence offered by the Antitrust Division was insufficient "both qualitatively and quantitatively" to prove that the merger would substantially lessen competition. Still, the merger movement in no way won a clear-cut victory, for Judge Bryan added, significantly, "The basic defect in the Government's case does not lie in its theories but in the nature and quality of its proof."[1]

While otherwise approving Judge Bryan's dismissal action and approving the principle of antitrust if not always the practice, I, for one, do question the theories now governing antimerger policy in the United States. My aim in the following discussion is to show that these theories are not protective but harmful to competition and hence harmful to economic growth. In particular, I recommend repeal of Section 7 of the Clayton Act of 1914 and its amendment, the Celler-Kefauver Act of 1950, in which it is stated:

"No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the

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[1] *U.S.* v. *Continental Can,* Civil No. 112-387, S.D., N.Y., Dec. 8, 1960.

Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."[2]

Such repeal, it is true, would probably have prevented a host of government anti-merger victories, including such prominent ones as those over Bethlehem-Youngstown (new Section 7) in 1958 and DuPont-General Motors (old Section 7) in 1957. It would have prevented the U.S. Supreme Court from laying down this rule in the case of the DuPont-General Motors stock acquisition: "The acquisition by one corporation of all or any part of the stock of another corporation, competitor or not, is within reach of Section 7 of the Clayton Act whenever the reasonable likelihood appears that the acquisition will result in a restraint of commerce."[3] But this is not to say that the government should not or would not be able to act in merger cases that are *truly* disruptive of competition. The Antitrust Division and the Federal Trade Commission would still possess the sizable weapons of Sections 1 and 2 of the Sherman Act.

Some distinction between Section 7 of the Clayton Act as amended and Sections 1 and 2 of the Sherman Act was brought out in hearings on the subject before the Joint Economic Committee in September, 1959, as follows:

"*Acting Assistant Attorney General in charge of Antitrust Robert Bicks:* We have treated thus far simple restraint-of-trade cases under Sherman Act, Section 1. I then proceeded to Sherman Act, Section 2, a larger monopolization area. I now turn to what I myself believe is the most significant antitrust enforcement act for the future. That is Clayton Act, Section 7. Clayton Act, Section 7 proscribes any acquisition of stock or assets that may substantially lessen competition or tend to create monopolies in any line of commerce in any sector of the country.

"There are two things to bear in mind. First, it applies only to acquisition. Sherman Act, Section 2 would *apply to monopolization whether by acquisition or internal growth.* [Italics are mine.]

"*Chairman Paul Douglas:* This was the so-called Kefauver Amendment?

"*Mr. Bicks:* Yes.

"Second, unlike the Sherman Act, it does not require proof of actual competitive harm. It requires simply proof of the probability of harm in the future. It reflects, I suggest, a Congressional desire to avoid the problems of monopolization by halting monopolizations or what is otherwise deemed excessive concentration, at its roots, by halting mergers that might threaten this effect."[4]

Why was Section 7 amended in 1950 when bills to do so had been before the Congress since the Temporary National Economic Committee hearings beginning in 1938? The aim was threefold: first, to make acquisitions of assets as well as stock of another corporation subject to FTC and Antitrust Division jurisdiction (this would close an escape hatch through which many an informal merger had been accomplished before 1950); second, to strengthen the hand of the anti-trusters in dealing with "reasonably probable" monopolization as opposed to actual monopolization; and third, to extend the coverage of the law to include vertical acquisitions (where the merging parties have a customer-supplier relationship) and conglomerate acquisitions (where the merging parties consist of businesses in different industries) so as to supplement the usual application of the law already covering horizontal mergers (acquisition transactions among competitors within the same industry).

The case that triggered Congress into passing the Section 7 amendment was that of Columbia Steel in 1948, the last merger case decided by the Supreme Court before the 1950 amendment to Clayton Section 7. U.S. Steel's Columbia Steel division had acquired Consolidated, a West Coast steel fabricator. The acquisition had both vertical



[2] Clayton Act, Amended Section 7, 64 *Stat.* 1125.
[3] *U.S.* v. *DuPont* (1957), 353 U.S. 586, 5.

[4] *Hearings before the Joint Economic Committee*, 86th Cong., 1st sess., Part 7, Sept. 22, 23, 24, and 25 (Washington: U.S. Gov't Printing Office, 1959), p. 2028.

and horizontal characteristics. In the vertical sense, U.S. Steel acquired a customer that had 3 per cent of the fabricated steel market in eleven western states. Measured horizontally, the merged companies had 24 per cent of the market for fabricated steel in these western states. The Court upheld the merger, stating: "We do not undertake to prescribe any set of percentage figures by which to measure the reasonableness of a corporation's enlargement of its activities by the purchase of the assets of a competitor. The relative effect of percentage command of a market varies with the setting in which that factor is placed."[5] This decision, based on the 1911 Rule of Reason interpretation of the Sherman Act in the classic Standard Oil case, upset influential members of both houses.

## ANTIMERGER POLICY

### Past Activity

I submit that Section 7, especially as amended in 1950, plays into the hands of some antitrust lawyers and economists who view almost every merger of big business and of many middle-sized businesses as monopolistic. In essence these guardians of competition say monopoly is a matter of numbers—the fewer the number of sellers in any market, the less the competition and the greater the monopoly. They also argue that mergers involve—as indeed they clearly do—a lessening of membership in an industry, presumably a buildup of "economic concentration," and, therefore, a degree of monopolization. Even so, the FTC reported a rate of about a thousand major mergers annually in 1959, 1960, and the first half of 1961.

So, what we seem to be witnessing is something akin to an irresistible force—the merger movement—meeting an immovable object—antimerger policy. In 1959 the Department of Justice filed 63 antitrust cases, 10 of them antimerger cases, a record for the department. In 1960 it broke this record and filed 92 cases, 11 of them antimerger cases. This antitrust and antimerger activity under the Kennedy administration appears to be even more vigorous. The 21 antimerger cases in 1959 and 1960 constitute nearly 60 per cent of the Clayton Act—Section 7 activity of the Antitrust Division since the Celler-Kefauver amendment in 1950. Antimerger activity by the Federal Trade Commission is also on the increase; 13 antimerger cases were started by the FTC in 1960, as compared with 3 in 1959.

Despite the seemingly small number of antimerger cases, antimerger policy is having a negative effect on merger activity, especially among the largest firms. This policy is preventing many mergers—however warranted economically—from coming into existence, that is, stopping them at the board room discussion stage or on the advice of counsel. Indeed, it is probably safe to say that many cowed corporations, especially the larger ones, have given up the search for profitable acquisitions and have fallen back on the relatively less expedient method of internal growth. Of this situation economist Donald Dewey of Columbia University, an authority on mergers and antitrust policy in the United States, writes:

> "In recent years, government success in discouraging mergers has been so striking that growth through mergers is now probably closed to most of the two hundred largest industrial firms. Henceforth they must expand by constructing their facilities or not at all; and if antitrust policy is to be anything more than the policing of cartels, its future will turn mainly on the economic consequences of banning growth by mergers in large firms."[6]

Or consider the recent off-the-record statement of one of the most brilliant antitrust lawyers in the country:

> "The principal thing is mergers. . . . On Section 7 there isn't a lawyer in the United States who knows what it means. . . . You can seek clearance from the Department of Justice, or you can go to the Federal Trade Commission and wear them to death. . . . You cannot win

[5] *U.S.* v. *Columbia Steel* (1948), 334 U.S. 495, 527-28.

[6] Donald Dewey, "Policy Toward Industrial Concentration in Britain and America," in Helmut Arndt, ed., *Die Konzentration in der Wirtschaft*, Part 2 (Berlin: Verlag von Duncker & Humblot, 1960), p. 1390.

against Department of Justice opposition; it's just whether they choose to bring a case against you, for they haven't the money to bring a case against everybody."[7]

### Motivation

What is the motivation behind the vigorous new antimerger policy, so clearly at odds with the former permissive and I believe more desirable merger policy as seen, for example, in the Supreme Court's upholding of U. S. Steel's acquisition of Consolidated in 1948? Part of the motivation, apparently, is the protection of small business and perhaps even an aversion to big business.

At this writing, the antitrusters are investigating or challenging mergers or proposed mergers in the banking industry and in such big businesses as Coca-Cola and Minute Maid, Campbell Soup and Pepperidge Farm, Burlington Industries and James Lees, Minnesota Mining & Manufacturing and Warner-Lambert, General Motors and Euclid Road Machinery, and Procter & Gamble and Clorox Bleach. To look at the last merger more closely, why did the FTC challenge the conglomerate merger of the nation's number one soap maker with the number one bleach manufacturer? It would appear that FTC Hearing Examiner Everett F. Haycraft, acknowledging that the action was the first such action ever brought by the commission, based his logic on the need for the preservation of smallness. Procter & Gamble's "ability . . . to acquire and retain valuable shelf space in grocery stores because of its advertising and promotional experience and financial resources,"[8] Haycraft stated, would lessen competition in an area so far dominated by small firms.

Another motivation in antimerger policy is control of the sellers in any one market, or what the antitrust lawyers and economists refer to as "economic concentration," "oligopoly," or "monopolistic competition"—the big twos, big threes, and big fours of U. S. industry. Instances where this has been the motivation include: Federal Judge Edward Weinfeld's point that legalization of the Bethlehem-Youngstown merger would lead to "triopoly" in an already highly concentrated steel industry;[9] the FTC's charge in its Pillsbury-Duff opinion that "in the urban markets at least, the mergers lead in the direction of what is sometimes called 'oligopolistic' or 'monopolistic' competition, that is, to a situation where the remaining competition in the particular market is between big companies";[10] and Federal Judge Randolph H. Weber's view in the Brown Shoe-Kinney Stores merger that "this Court . . . finds that as the Brown-Kinney experience is weighed in the same scale with what is happening in the industry in large manufacturer-retail outlet acquisitions, the trend is toward the eventual elimination of small manufacturers and independent retailers."[11] In these three instances, along with many others, mergers or proposed mergers were upset. The antitrusters are determined that oligopoly—whatever it is, for there is no unanimity on a definition in the economic literature—will not get out of hand and small business will be protected.

## AGAINST ANTIMERGER POLICY

### The Language

The case against Section 7 is based mostly on economic grounds, but one judicial ground deserves mention. This is the reversal in Section 7 of one of the most fundamental of Anglo-American legal traditions: that, under the rule of corpus delicti, proof of wrongdoing must be clear cut and actual. The crime, in other words, must be real, not assumed, not hypothetical. But in the language of the amended Section 7, a merger is illegal when its effect "may" be substantially to lessen competition or "tend" to create a monopoly. Here the use of "may" and "tend" is extremely weasel-worded, and corpora-

[7] Private interview.

[8] *Procter & Gamble* (1960), FTC 6901, initial decision.

[9] *U.S.* v. *Bethlehem Steel* (1958), 168 Fed. Supp., 576 (S.D., N.Y.).

[10] *Pillsbury Mills* (1953), 50 FTC 555.

[11] *U.S.* v. *Brown Shoe* (1959), 179 Fed. Supp., 721, 740 (E.D., Mo.).

tions may well be condemned for crimes or acts that they did not in fact commit. Certitude is missing, and bureaucratic arbitrariness—what Roscoe Pound, Emeritus Dean of the Harvard Law School, calls "administrative law"—sets in. Assumptions of an uncertain nature in an uncertain future as related to a "reasonable probability" are made and counted as "evidence." As Judge Weinfeld admitted in the Bethlehem-Youngstown case:

"The Government is not required to establish with certitude that competition in fact will be substantially lessened. Its burden is met if it establishes a reasonable probability that the proposed merger will (may) substantially lessen competition or tend to create a monopoly."[12]

The word "may" was seen as a trap by such a staunch friend of a vigorous antitrust policy as Joseph O'Mahoney, then senator from Wyoming, during the debate on the Celler-Kefauver amendment in 1949. Said the senator:

"Mr. President, the difference between the word 'will' and the word 'may' is almost as great as the distinction between the poles. . . . I prefer the word 'will' to the word 'may'; because if we use the word 'may', no one under the sun can tell what the law means, because 'may' conveys into the hands of some future Federal Trade Commission the power to hold . . . practices to be illegal, although the Federal Trade Commission now says they are not illegal."[13]

The impreciseness of language in the amended Section 7 does not stop with the use of the words "may" and "tend." The law provides no fixed criteria for what it means by the phrase "line of commerce," no set standards for what it means by "section of the country," and no sharp guidelines for what it means by "substantially to lessen competition." Are cellophane and polyethylene film in the same "line of commerce"? Does a "section of the country" cover a village, city, state, or multistate area? Just how substantial is "substantially"? It is not likely that any two lawyers or economists would define these phrases in the same way. The result is slippage into the arbitrary mire of administrative law. Even one of the authors of the Celler-Kefauver amendment was upset by the language that crept into the bill and was enacted into law. Said Congressman Emanuel Celler during the House debate:

"The phrase 'to restrain commerce in any section of the country' is new phraseology. I have not heard that before in any antitrust legislation or in any Federal Trade Commission legislation. It would give rise to all manner of questions, of controversies, and of disputes; there would be nothing but confusion. It would mean a field day for the lawyers."[14]

The Celler fears of gross inexactitude of language in the phrase "in any section of the country" were realized in, among others, the Bethlehem-Youngstown case. There, the opinion of the court, which accepted the arguments of the Antitrust Division, managed to set up five geographical markets for steel products as they supposedly related to the two steel corporations. First, there is the northeastern section of the United States, a three-state market region within it, and then three individual state markets, Ohio, Michigan, and Pennsylvania. But this pat dissection of steel markets does not correspond to the facts. Steel markets are not rigid and static; they are dynamic and responsive to many variables such as technology, price and quality competition, varying transportation charges, and widely different products. Commenting on the reasoning in the Bethlehem-Youngstown case, M.I.T.'s Professor M. A. Adelman, one of the ablest antitrust economists in the country, said:

"This sinks error into chaos. If the northeast quadrant is a market area—is the locus of the supply-demand forces that determine the price —then the other two areas are not. The evidence that sustains any one of the three market concepts necessarily condemns the others. Until there is a retreat from Bethlehem to reason, tribunals will be able to decide according to any

[12] *U.S. v. Bethlehem Steel,* 576.

[13] *Congressional Record* (Aug. 12, 1949), p. 11344.

[14] *Congressional Record* (July 7, 1949), p. 9061. The field day Congressman Celler refers to has also been one for economists, whose fees for counsel and testimony in antitrust cases run anywhere from $75 to $200 a day.

visceral whim, by manipulating market definitions."[15]

Similarly, what constitutes market control in the eyes of our antimerger officialdom is anything but consistent. In his Alcoa opinion, the late Judge Learned Hand made the observation that a company that held 90 per cent of a market was undoubtedly guilty of illegal control, but 64 per cent was of doubtful legality, and 33 per cent was certainly legal.[16] Yet the FTC held that 45 per cent was prima facie evidence of violation of Section 7 in the Pillsbury-Duff case. In other cases brought by the FTC and the Antitrust Division, critical market shares usually begin around the 15 per cent mark. But in the Brown Shoe-Kinney Stores case, the manufacturing capacity of Brown Shoe would have increased only one-half of 1 per cent if the Brown Shoe-Kinney merger had gone through, making a total market share of only 5 per cent. Even so, the Court ruled against the Brown Shoe-Kinney merger.



## DEFINING INDUSTRIES

Aside from inconsistency in the definitions of critical market shares, the antitrusters do not seem to realize the amorphous nature of an "industry" in a dynamic free-enterprise economy, the tremendous power of competition even when the market share reaches 100 per cent. Years ago, for example, there was no safer investment than the stocks of streetcar companies; today hardly any of these regulated "monopolies" are left in America. That industry is gone, a victim of, among other competitive offenders, the motor car.

Market fences separating other industries are falling away. Plastic companies are invading steel markets; chemical companies are going into plastics; rubber, distilling, and meat-packing companies are going into chemicals; oil companies are invading rubber markets; aircraft concerns are going into hydrofoil boats; telephone companies are moving into intercom systems, and so on. As a result, a given "industry" becomes elusive, statistically and conceptually. In 1953, for example, the Supreme Court held that DuPont's 75 per cent share of the U.S. cellophane market did not constitute a monopoly, since cellophane in accounting for only one-sixth of the total market for flexible wrappings did not constitute a complete market. DuPont itself exemplifies the difficulty of industrial classification. Most classifiers place it in the "chemical" industry, but it also properly belongs to a host of other industries—textiles, explosives, paint, plastics, metals, photographic film, and so on.

There are other examples of conceptual problems in defining an industry. For instance, in the FTC's 1954 report on concentration ratios for 114 individual "industries," there are many industries where a large share of primary products are produced by other industries. For example, more than one-half of all advertising novelties were produced by firms outside the signs and advertising displays industry. Almost half of all laminated glass was manufactured by concerns not included in the purchased glass industry, although laminated glass is a key primary product. Again, nearly half of all open die or smith steel forgings were manufactured outside the iron and steel forging industry. In the window and door screen industry, more than half of all wood screen doors and windows came from other industries omitted from the FTC's "concentration" ratio.

## COMPETITION FOR MONOPOLIES

Another angle seemingly not taken into account by the antitrusters in their antimerger policy is that monopoly and oligopoly—when attained through efficiency in fields charac-

[15] M. A. Adelman, "The Antimerger Act, 1950-1960," *American Economic Review Papers and Proceedings* (May, 1961), p. 237.

[16] *U.S.* v. *Alcoa* (1945), 148 F. 2d 416, 424 (2d cir.).

[17] For an interesting discussion on the economics and legislation of competition in America, see Claude Robinson, *Understanding Profits* (Princeton, N.J.: D. Van Nostrand Co., Inc., 1961), chaps. 9 and 10.

terized by freedom of entry—are not necessarily incompatible with competition.[17] The monopolist as a single seller is forced to behave quite competitively because he faces potential competition, foreign competition, competition of substitutes, and the sort of competition imposed by elasticity of demand. In the United States thousands of different goods are produced by a single producer from small goods available in variety stores to large custom-built goods available from machinery manufacturers; yet almost all are sold at competitive prices.

One reason for this lies in the potential competition of scores of would-be producers avidly watching from the sidelines. Potential competition exists as long as there is freedom of entry into an industry, as long as the government does not block entry with undue franchises, overregulation, high tariffs, import quotas, licenses, and other controls (not including patents, which are property rights and encourage competition by stimulating innovation and invention).

Most large industrial corporations are constantly searching for new lines, new products, and new investments whenever and wherever the return on capital is enticing. Those who argue that freedom of entry is barred when capital requirements are "excessive" overlook the giants, such as Armour, which have had the resources to become giants in a new field, chemicals in Armour's case. Again, to ease the burden of high capital requirements, there is the possibility of joint ventures when corporations make a team effort in a big new joint enterprise. An example of this is the new Cerro Corporation-National Distillers agreement to jointly put up and operate an aluminum refinery in Oregon.

Too, monopoly that becomes a monopoly by virtue of its own efficiency must constantly be on its toes, must act competitively, and must assume it is surrounded by potential competitors eager to absorb its market. Otherwise, it will not be a monopoly for long. Before World War II, Alcoa drove down the price of a pound of aluminum from dollars to pennies although it was virtually alone in the field. One reason for Alcoa's action may well have been potential competition.

Foreign competition is another factor that tames monopolists and undermines production and market share calculations—as long as the government does not levy onerous tariffs, quotas, and other restrictions against foreign goods. (The Dingley Tariff of 1897, it will be remembered, was known as "the mother of trusts.") Even now the antitrusters are training their guns on General Motors, counting up G.M.'s more than 50 per cent share of the American auto industry. But this calculation neatly omits the foreign car manufacturers—Volkswagen, Renault, Austin, Fiat, and more than forty other auto makers who invade our shores. Precisely the same error of ignoring competitors outside the *national* industry is made in the case of American steel manufacturers, plywood producers, and typewriter makers, to name but a few. Free trade is highly conducive to domestic competition and efficiency, in addition to its advantages of international cooperation, good will, and higher living standards in the affected nations.

Competition of substitutes also plays havoc with "market shares" and monopolists who would otherwise refuse to act competitively. In quite a number of fields, the competition of substitutes is keener than the competition from producers in the same field. Wooden boxes compete against paperboard boxes, aluminum cans against "tin" cans, metallic containers against polyethylene containers, cellophane wrapping against waxed paper, copper cable against aluminum cable, newspapers and magazines against television and billboards, and so on practically ad infinitum. The railroad "monopoly" has long since been effectively challenged by truckers, pipelines, airlines, and water transportation (but the ICC seems unable to recognize the situation).

### Elasticity of Demand

With elasticity of demand, the monopolist will be under profit pressure to charge not the highest price possible but the price that will yield the highest net revenue. In a way,

Henry Ford, Sr. was a monopolist, a monopolist of low-priced autos; yet he did not charge what the traffic would bear. He drove down the price of a Model T hundreds of dollars to, at one point, $295, and declared it could be "any color as long as it's black." Any novelist is, by definition, a monopolist, and he and his publishers are free to place any price they wish on a novel—but they do not. Price maximization, in sum, is not the same as profit maximization.

### THE CASE FOR MERGERS

It follows from this reasoning that the stifling effect of antimerger policy on a more efficient structure for American industry and commerce cannot be exaggerated. What many opponents of the merger movement forget is that mergers make it possible to eliminate duplication and waste. Mergers allow for the adoption of economies of scale, more and better research, a fuller line of products, and better service to customers. In brief, mergers permit stronger competitive units. Thus, as a rule, they are symbols of the strengthening of competition, not the weakening of it. They contribute powerfully to economic growth. Furthermore, despite the many mergers that have taken place, the business birth rate has not flagged. In fact, for years the business birth rate has far surpassed both the merger rate and the business mortality rate combined. The *Statistical Abstract of the United States: 1961* shows a gain in the number of U.S. firms from 3.1 million in 1945 to 4.7 million in 1960,[18] and that indicates clearly the openness of the American enterprise system. (Of course, the business birth rate in the service industry is greater than that in manufacturing.)

Notwithstanding this growth, antimerger policy still stifles business enterprise and economic growth by tending to freeze the structure, the *status quo,* of U. S. industry. Under the authority of amended Section 7, the government has cast a doubt on the title of every transfer of stock and productive assets from one company to another. And, as seen in the DuPont-General Motors case, the FTC or the Antitrust Division will bring an action on the basis of Section 7 against a transaction that occurred forty years earlier. With such a principle and such a precedent, future as well as past mergers are under a cloud.

In addition, antimerger policy — supposedly designed to safeguard small business—handicaps and penalizes the small and medium-sized corporation from selling out and buying out and thereby has inadvertently protected the large corporation, whether efficient or inefficient. By blocking the merger road to the efficient large corporations, antimerger policy has to that extent weakened the ability of big businesses and small businesses to serve America better and hasten our economic growth. The stake of small business in better official merger policy is especially critical. Of late the FTC and the Antitrust Division are also blocking mergers of smaller firms. Thus, as the Lintner-Butters mergers study of 1950 noted:

> "For all manufacturing and mining companies during the eight-year period 1940-47, mergers were a *much less* important source of growth for large companies than for smaller companies. . . . To sum up, mergers have been responsible for such a small percentage of the total growth of large firms since 1940 that their effect on over-all levels of industrial concentration has been very small."[19]

So, I hold antimerger policy has slowed economic growth. John E. Swearingen, President of Standard Oil of Indiana, put it this way: "On occasions the Department of Justice seems to be seeking for ways to place roadblocks in the way of business expansion."[20] Mergers usually represent a way of competing more aggressively and efficiently,



[18] U.S. Bureau of the Census, *Statistical Abstract of the United States: 1961* (82d ed.; Washington: U.S. Gov't Printing Office, 1961), p. 480.

[19] John Lintner and J. Keith Butters, "Effect of Mergers on Industrial Concentration, 1940-47," *Review of Economics and Statistics* (February, 1950), pp. 31-32.

[20] John Swearingen, "Government and American Business," speech before Texas Mid-Continent Oil and Gas Association, Sept. 27, 1961.

a situation well summed up in the Standard Oil of California dissent by Justice Robert H. Jackson, with whom Chief Justice Fred M. Vinson and Justice Harold H. Burton joined, when he said: "If the courts are to apply the lash of the antitrust laws to the backs of businessmen to make them compete, we cannot in fairness also apply the lash whenever they hit upon a successful method of competing."[21]

To be sure, the antitrusters can find support for their antimerger theory among the academic economists, a considerable number of whom accept the theory of imperfect competition promulgated by Edward H. Chamberlin of Harvard University and Joan Robinson of Cambridge University.[22] In essence, this theory holds that "imperfections" characterize all of our industrial and commercial competition. (Wheat farmers have perhaps the least "imperfect" competition, and their competition is characterized as "perfect" or as "pure.") Indeed, the imperfection in American competition is so great that many economists cannot see the competition for the monopoly. Hence, we have monopolistic connotations attached to terms used to designate U.S. competition –such terms as product differentiation, administered prices, price uniformity, price leadership, contrived scarcity, duopoly, oligopoly, vertical-horizontal-and-conglomerate mergers, quantitative substantiality, and so on.

But as economist F. A. Hayek of the University of Chicago has wryly observed, "imperfections" are to real competition what gasoline is to an engine.[23] The fuel for competition is the imperfections–the individual and corporate superiorities or inferiorities of resources, skills, innovations, and technology in each competitor plus the ability or salesmanship to quote prices, advertise, "differentiate" products, create new markets, and influence by such means as packaging.

Yet another name for "imperfections" in the economic sense is quality, as Professor Lawrence Abbott of Union College brings out in his study, *Quality and Competition.*[24] Professor Abbott argues tellingly that quality competition is discounted by the monopolistic-imperfect competition theorists, and that far from being monopolistic, quality differences widen the area of choice, differentiate the cost and value of competing products, and thereby add fuel to competition. In fact, the *Attorney General's National Committee To Study the Antitrust Laws* referred to the theoretical construction of the monopolistic - imperfect competition models when it declared, "We do not regard these models as offering any basis for antitrust policy. Indeed, departures from conditions of pure or perfect competition are inevitable, pervasive and many of them useful to competition as a dynamic process."[25]

Mergers are a necessary means of effecting competition, of streamlining the industrial and commercial structure of the U.S. economy. My reason for wanting a new, more positive, and more constructive approach toward the merger movement lies in what I hold is the need for a new look at competition in America, a look along the lines of the Brookings Institution study of big business published in 1954 and prepared under the direction of A. D. H. Kaplan. This study, *Big Enterprise in a Competitive System,* proved quite conclusively that the industrial giants–many of which achieved size through mergers–are not insulated from the forces of competition. As Kaplan saw after noting the changing lineup of big firms

[21] *U.S.* v. *Standard Oil of California* (1949), 337 U.S. 293, 305.

[22] Edward H. Chamberlin, *The Theory of Monopolistic Competition* (Cambridge: Harvard University Press, 1933), and Joan Robinson, *The Economics of Imperfect Competition* (London: The Macmillan Co., 1933).

[23] From John Chamberlain, *The Roots of Capitalism* (Princeton, N.J.: D. Van Nostrand Co., Inc., 1959), p. 158.

[24] Lawrence Abbott, *Quality and Competition* (New York: Columbia University Press, 1955).

[25] *The Attorney General's National Committee To Study the Antitrust Laws* (Washington: U.S. Gov't Printing Office, 1955), p. 316.

through the years, the top is a slippery place. He wrote, "There is no reason to believe that those now on top can remain there any more than their predecessors, short of alert participation in continuous product and market development."[26] And yet practically all of the statistics on which the Kaplan study is based go back to before 1950, the year of the passage of the Celler-Kefauver amendment to Section 7.

[26] A. D. H. Kaplan, *Big Enterprise in a Competitive System* (Washington: The Brookings Institution, 1954), p. 142.

I agree a merger could be an impediment to competition and efficiency. But the Supreme Court's Rule of Reason of 1911 should apply. The lowering in the number of firms in an "industry" should not necessarily be equated to an injury to competition; it could mean the strengthening of competition. The test of restraint of trade must not be narrow and arbitrary; it should be based on actuality and certainty, not probability and unsettled theory. Sections 1 and 2 of the Sherman Act can handle this job. Section 7 and its 1950 amendment unreasonably restrain trade and should be repealed.



One of the most striking features of the economic organization of the Middle Ages was the important role played by the fairs, more especially down to the end of the thirteenth century. . . .

If we examine the geographical distribution of the fairs, it is at once apparent that the busiest among them were grouped almost half-way along the great trade route, which ran from Italy and Provence to the coast of Flanders. These were the famous "fairs of Champagne and Brie" which followed each other through the whole course of the year. First came the fair of Lagny-on-the-Marne in January, next on the Tuesday before mid-Lent that of Bar, in May the first fair of Provins, called the fair of Saint Quiriace, in June the "warm fair" of Troyes, in September the second fair of Provins or the fair of Saint Ayoul, and finally, in October, to end the cycle, the "cold fair" of Troyes. In the twelfth century, these assemblies continued for about six weeks, leaving only the necessary interval for the removal of wares.

—*Henri Pirenne*
ECONOMIC AND SOCIAL HISTORY OF MEDIEVAL EUROPE

# BOOK NOTES AND REVIEWS

*editor* **Lois Headings**

## HUMANITY: SENSE AND ICON

*"After all, we are not born human; we must earn the title."* (Lawrence Durrell)

*"Once ideologies become idolatries, automatic systems of thought rise like a wall between the spirit and reality, dimming the spirit and dulling the hearing."* (Eugene Jones in *Atlas*, April, 1961)

One courts danger in seeking novelty of thought above all else, especially since much that at the time seems novel turns out to be, upon a small amount of research, old wisdom refurbished in new jargon. On the other hand, one equally courts danger in resting content with stereotypes, or in mistaking stereotype for reality. Sometimes stereotypes become so dear that one who accepts them is threatened when they are shown to be more fiction than fact. Patterns of thought and belief can thus become deadening rather than enlivening: Instead of being conducive to growth, they cripple. From this point of view, we looked among various periodicals from the past year's output not for novelty alone—for some of the ideas were really old ones badly in need of revival—but for both the sensible and the "far out." We believe, after much scanning, that the first is as unusual as the second.

Before launching into the material we intend to discuss, we want to report on our perusal of two new magazines, *Atlas* and *Current*, and that opulent French publication, *Réalités*. We have great admiration for the work of both *Atlas* and *Current*. *Atlas*, as we have mentioned before, is a reprint magazine from newspapers and magazines around the world. The items include comments from all ideological camps, the criterion for inclusion being not their palatability to native consumers but their degree of influence throughout the world. As *Atlas'* publisher remarks, the staff itself deplores many of the opinions but publishes them because they need to be known. The editors do in some sections (particularly in the arts sections) select material for its merit. To us, at least, much of the material came as a distinct shock—like a cold shower, uncomfortable but bracing. *Current* is a digest magazine that employs both selected direct quotations and summary. Its purpose is to expand the number and effectiveness of concerned citizens, and it publicly eschews either liberal or conservative affiliation (although to date we find a slight bias toward liberal sources). Further, it extends its coverage to less accessible materials such as *Columbia University Forum*, *Phylon*, and *The Journal of Conflict Resolution*, and to publications of the Urban Land Institute, RAND Corporation, and Twentieth Century Fund, in addition to the expected *Foreign Affairs*, *Harper's*, and *The Saturday Review*. We recommend it highly to the reader with little time but with a large appetite for authoritative information.

Among the *Réalités* articles, we found these especially commendable: Danielle Hunebelle's "How the Other Half Lives" (April, 1961), an astringent report on the people of East Germany; the stories of the nationalized French aircraft corporations Caravelle and Nord-Aviation (May, 1961); the delightful interview, "Lawrence Durrell: An Exclusive Interview" (April, 1961); the juxtaposition of articles on Le Jockey Club and Sartre—the latter with some wonderful photographs of St. Germain-des-Prés and Deux Magots (March, 1961); Michel Bagot's "Roger Planchon: Boy Wonder of European Theatre" (January, 1961), which makes even off-Broadway theatre seem anemic; and the entire August, 1961 issue on "The Mediterranean Sea: A Confluence of East and West"—in particular José André Lacour's brief "The Templars—Mystic Builders of Freemasonry."

While reading *Commentary* we were struck by the contrast between the conformist dissent and maverick conservatism that we came across.[1] The first was the point of a review by Seymour Lipset of Vance Packard's *The Wastemakers* called "The Conservatism of Vance Packard," in the January, 1961 issue. In referring to Packard, Lipset says:

"Here is no radical critique of American capitalist commercial civilization but a nostalgic rejection of a materialistic culture written for those who believe that the only good society was the pre-industrial, pre-commercial, agrarian civilization. This nostalgia for the primitive, the rural, and the small town, is, of course, the nostalgia of the wealthy ex-urbanite for a world in which he does not live; and who, further, though he feels guilty about all the abundance he shares, is still determined to keep it. He may read *Consumers' Reports*, but he buys his Oldsmobile, or Lincoln, or Triumph. He

[1] Ideological handles like "conservative" and "liberal," "radical" and "progressive" are growing more confusing with the output of each day's presses. What is more, everybody these days claims to be a rebel, whether against the New Deal or "Pleistocene politicos." So if our terminology at first seems contradictory or inconsistent, we trust that the discussion will clear it up in due time.

conforms, but he loves to think of himself as a rebel." (p. 83)

But Lipset claims that the only effective answer to the ills that Packard relates are institutional reforms that he (Packard) deliberately and consistently evades. Lipset remarks that one way to reduce the influence of advertisers would be to place heavy taxes on advertisements, or to curtail the current subsidy given to advertisers in the form of cheap mailing rates for large-circulation magazines and, as he says, "junk mail." This may all be very true, but Lipset's most telling criticism of Packard rests in those paragraphs in which he points out the basic superficiality of Packard's conclusions and his haphazard treatment of evidence. As for the desirability of institutional changes for correcting all of society's ills, old-line progressives who advocate such increased central government action are being countered by an outcropping of old-line liberals in spots as unlikely as the New School for Social Research. We are thinking particularly of Ernest van den Haag.

Another such maverick that comes to mind is Paul Goodman, author of last year's popular study of juvenile delinquency, *Growing Up Absurd*. This labelling of these two may be misleading, however, for we suspect that at least some of what has been called the trend toward conservatism is merely a refusal to be satisfied with the doctrinaire clichés of either right or left. Van den Haag, for example, takes a perverse delight in refusing to be classified, and consequently angers and bewilders many of his fellow sociologists. In September, 1960, van den Haag wrote an article for *Commentary* entitled "Affluence, Galbraith, the Democrats," which provoked a fairly warm joint answer from a fellow sociologist and a labor economist in the January, 1961 issue of *Commentary*. They claim with some indignation that van den Haag "revolves on his axis with such rapidity that one can't see his face at all. He would like to have one foot in the liberal camp and the other in the conservative, while at the same time giving the impression that in some way he would like to be a radical." (p. 70) In his article van den Haag had criticized Galbraith's answer to the question what can be done to assure more reasonable use of our affluence. Galbraith, according to van den Haag, thinks that people spend their money foolishly and that the government therefore should spend more of it for them. Van den Haag suggests that the answer instead should be that the purchasing power of individuals in the lower income groups be increased. He then makes the assertion that individuals are likely to be better judges of their needs than the government, and moreover, that they are entitled to their mistakes. Van den Haag's critics insist that he is merely a follower of what they call "competitive nihilism" or the free-enterprise wisdom of von Mises, Hayek, and the nineteenth-century predecessors of those worthies. In reply to this attack, van den Haag says:

"I think very highly of Hayek, although I also accept many views of Lord Keynes which Hayek rejects; on economic matters, I am nearer to my friend A. P. Lerner. But I also agree on some matters with Paul Goodman, and on many more with Russel Kirk or William Buckley; I often concur with and always admire Sidney Hook. In short, my guilt by intellectual association is infinitely greater than [my critics] suspected. (I feel better now that I have confessed.) The world is complicated though; sometimes I agree with [my critics] too; and I am certainly awed by the vigorous Procrustean spirit which enables them to take the world's measure in so clean-cut a fashion. It is not among my gifts." (p. 73)

Generally, van den Haag advocates the decentralization of mass media—making them, that is, more directly dependent upon their publics. Similarly, he advocates more local government autonomy as opposed to central government enlargement. He protests at this point that his opposing the trend toward more collective expenditures does not mean that he opposes *any* collective expenditures. He believes that the relative efficacy of private enterprise over public enterprise in any field should be judged upon empirical grounds.

An unexpected reaction against increased government centralization is also apparent in Paul Goodman. As in van den Haag's case, Goodman spells out his social philosophy best under fire. It is in response to criticism of an earlier article ("Pornography, Art and Censorship" in *Commentary*, March, 1961, p. 203) that Goodman clarifies what he calls "my libertarian position." He refers to himself as "a community anarchist who believes that coercive sovereign power is always a poor expedient." (*Commentary*, August, 1961, p. 159) Later, he says "For me, almost always the principle of decentralized power is overriding and should be fostered." (p. 161) However, he maintains that he is for changes and for very far-reaching changes, changes that he

rightly calls revolutionary. But he feels that they should be changes only "in people in their localities." He quotes de Tocqueville's "'A democracy without provincial institutions has no security against the excesses of despotism. How can a populace unaccustomed to freedom in small concerns learn to use it temperately in greater affairs?'" (p. 161) Appropriately, Goodman's freedom is a freedom to act instead of a freedom of protection. Mere freedom from interference is trivial, he says. While people may feel themselves inviolate in their rights and their families, they are effectually hemmed in and imposed on and their resources for action preempted. "Soon, formally free, they are powerless and enslaved." (p. 159) Goodman would make a distinction between, for example, what he calls a merely juridical person and a man who can grow in his community and its history. "Our rights as juridical persons, that make society our own as citizens and give us dignity, must be continually fought for by free growing and initiation; otherwise they are empty." (p. 160) He continues by saying that now "We are in the age of organized affluence, of automatic technology, feudal monopoly, and symbolic democracy; and the universally prevalent ideology is that Nothing Can Be Done. Therefore, naturally, 'freedom' no longer has anything to do with ongoing initiation; it has become the protection of cowering individuals. Such freedom leads to fascism." (p. 160)

Goodman's calling himself a "community anarchist" becomes clearer in his article "Utopian Thinking" in *Commentary* (July, 1961). He believes in revivifying what he calls "the conflictful community." Contacts between unlike people should be maintained so that the quarrels of ordinary personal and community life, with their attendant opposing values, must be resolved in face-to-face fashion, thereby preventing stereotypes and rationalizations. For example, says Goodman, "It is better if city planning is done by competitive projects, exhibited, explained, and submitted to a popular referendum, rather than handed down by official agencies. People might choose unwisely, but they would be educated in the process, and in the fairly short run there would be better planning." (p. 26) Goodman finds basically dehumanizing the withdrawal from conflict into conformity and privacy and a reliance on dicta handed down from central authorities.[2] Presumably, he would find acting only within one's own organization or power block equally stultifying. It is true that the increasing trend of mobile urbanites to become isolated into occupational or religious or social groups leads to a growth in distrust, suspicion, and dislike between groups. The mutual misconceptions and misunderstandings, for example, between the professor and the practical man of affairs in America can be traced directly to general lack of contact. In England, due to its famed Establishment, the social connections between these two are close and contacts are frequent. And as a result, both profit.

We have somewhat belatedly discovered the influential *Encounter*, which has been in publication since 1950 in England. Cursed by the more leftist British press as an "Establishment magazine," it is actually an Anglo-American enterprise. Its sponsor is the Congress for Cultural Freedom, an international organization of eminent intellectuals, founded on the proposition that "there can be no stable world as long as mankind, with regard to freedom, remains divided into 'haves' and 'have nots.' . . . exist-

[2] This article is a chapter of Goodman's forthcoming book, *Utopian Essays and Practical Proposals,* which we hope to report on later.

**PEOPLE WILL BE TALKING ABOUT**

RECENT

*Ludwig Bemelmans,* BEMELMAN'S ITALIAN HOLIDAY (Houghton)

*Jorge Luis Borges,* LABYRINTH AND OTHER WRITINGS (Internat'l prize winner; New Directions)

*David Boroff,* CAMPUS U.S.A.: PORTRAITS OF AMERICAN COLLEGES IN ACTION (Personality sketches of several universities; Harper)

*Wally Cox,* MY LIFE AS A SMALL BOY (S. & S.)

*Peter DeVries,* THE BLOOD OF THE LAMB (Little)

*Gerald Durrell,* THE WHISPERING LAND (Animal collecting in S. Am.; Viking)

*Christopher Fry,* CURTMANTLE (New play; Oxford)

*Romain Gary,* PROMISE AT DAWN (Self-portrait; Harper)

*Jack Gelber,* THE APPLE (Grove)

*Michael Goodman,* THE END OF IT (Horizon Pr.)

*A. S. Graham,* THE EAVESDROPPER (*New Yorker* fantasies; Dial)

*John Howard Griffin,* BLACK LIKE ME (Autumn 1959, author went to the South with skin chemically blackened; Houghton)

ing freedoms, the re-conquest of lost freedoms, and the creation of new freedoms are part of the same struggle." *Encounter* articles in the main are considered and authoritative; if such are Establishment views, then the above curse is deserved.

Richard Lowenthal on the changing role of the United States in world affairs and Theodore Draper on Cuba have roused particular controversy. Lowenthal generally writes the feature section entitled "International Commentary." In the August issue, his article "The Balance and the Mission: The Change in World Role of the U.S.A." first sets out the changes in Russian and U. S. relations since World War II, principally since 1957, and second, describes three main positions that have evolved in the United States in response to the new situation. Immediately after World War II, says Lowenthal, the United States could deal with Stalin's challenge from our strong position of nuclear monopoly. Even when this monopoly was broken, America still remained invulnerable to long-range thermonuclear attack until 1957 with the launching of the Sput-

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*John Harris*, COVENANT WITH DEATH (World War I novel; Sloane)

*Ben Hecht*, PERFIDY (On Israel; Messner)

*Weldon Hill*, THE LONG SUMMER OF GEORGE ADAMS (Author of *Onionhead;* McKay)

*John F. Kennedy*, WHY ENGLAND SLEPT (Funk & Wagnalls)

*Henry Miller*, STAND STILL LIKE THE HUMMINGBIRD (Short stories; New Directions)

*Alberto Moravia*, THE EMPTY CANVAS (Farrar)

*Anthony Nutting*, LAWRENCE OF ARABIA: THE MAN AND THE MOTIVE (Potter)

*John O'Hara*, ASSEMBLY (Short stories; Random)

*Caesare Pavese*, THE BURNING BRAND: DIARIES 1935-1950 (Private diaries; Walker)

*Caesare Pavese*, THE HOUSE ON THE HILL (Award-winning Ital. novelist; Walker)

*Robert Payne*, PORTRAIT OF A REVOLUTIONARY: MAO TSE TUNG (Abelard)

*Mari Sandoz*, THESE WERE THE SIOUX (Hastings House)

*N. F. Simpson*, ONE WAY PENDULUM (N. Y. play of solemn lunacy; Evergreen Orig.)

*Edgar Snow*, RED CHINA (Random)

*Robert C. Tucker*, PHILOSOPHY AND MYTH IN KARL MARX (Cambridge)

*Robert Penn Warren*, WILDERNESS (Random)

*Evelyn Waugh*, THE END OF THE BATTLE (Little)

*John A. Williams*, NIGHT SONG (N. Y.'s jazz underworld; Farrar)

*Angus Wilson*, THE OLD MEN AT THE ZOO (England in 1970 under a Uni-European dictatorship; Viking)

*Colin Wilson*, ADRIFT IN SOHO (Houghton)

*Edmund Wilson*, WILSON'S NIGHT THOUGHTS (Farrar)

FORTHCOMING

*Saul Bellow*, MR. HERZOG (Major novel; Viking)

*Robert Benton and Harvey Schmidt*, THE WORRY BOOK (Viking)

*John Braine*, COUNCILLOR LAMPTON (Sequel to *Room at the Top;* Houghton)

*E. R. Braithwaite*, A KIND OF HOMECOMING (Author of *To Sir with Love;* Prentice)

*Leonard Cottrell*, THE TIGER OF CH'IN (Hist. of China to great dynasties; Holt)

*Maurice Druon*, THE LILY AND THE LION (Scribners)

*Friedrich Duerrenmatt*, THE QUARRY (N. Y. Graphic Soc.)

*Paul Goodman*, UTOPIAN ESSAYS AND PRACTICAL PROPOSALS (Random)

*Christopher Isherwood*, DOWN THERE ON A VISIT (Four autobiog. stories; S. & S.)

*John Knowles*, MORNING IN ANTIBES (Author of *A Separate Peace;* Macmillan)

*Norman Mailer*, DEATHS FOR THE LADIES AND OTHER DISASTERS (Poetry; Putnam)

*Claude Mauriac*, THE MARQUISE WENT OUT AT FIVE (Braziller)

*Francois Mauriac*, CAIN, WHERE IS YOUR BROTHER? (Coward)

*Theodore Morrison*, THE WHOLE CREATION (Novel about biologist, novelist, and industrialist; Viking)

*Muriel Spark*, THE PRIDE OF MISS JEAN BRODIE (Lippincott)

*Anthony Standen*, MORE SACRED COWS: LITTLE HERESIES IN AMERICA AND ELSEWHERE (Morrow)

*A. J. P. Taylor*, THE ORIGINS OF THE SECOND WORLD WAR (Controversial Brit. historian; Atheneum)

*Barbara Tuchman*, THE GUNS OF AUGUST (Macmillan)

nik. This leveling of the military balance interacted with the upsetting of the political balance by the increase in revolutionary movements in the underdeveloped regions of the world. What has evolved, therefore, is an unstable balance of world power coupled with nuclear parity.

"What is at stake in the present debate in America, inside and outside the administration, is nothing less than the need to re-define the world role of the United States in terms of a world in unstable balance, and to get the definition understood and accepted by the nation at large. . . . Even before the Vienna confrontation, the discussion on the changing world role of the United States was, in fact, in full swing. It centres on the question whether the U.S.A. should try to maintain all its world-wide commitments in the new situation—and if so, by what means. Three main positions have crystallised in this debate, and each implies a different view about the nature and mission of U.S. power." (pp. 65-66)

The first position is that of "No Retreat," and is based upon what D. W. Brogan calls "the illusion of omnipotence." It advocates, continues Lowenthal, maintaining all commitments and putting American troops in to fight for them whenever necessary. This school sees the American mission as identical with world-wide extension of American military power—at the same time that all realistic estimates of actual American military power have vanished. Opposing this school is one that favors a drastic cutting of military commitments outside Western Europe and proposes policies supporting the neutralist regimes instead of the present Asian allies of the United States. Both groups apparently believe that there is no popular basis in any underdeveloped country for active opposition to Communism. Lowenthal says that this view oversimplifies the Asiatic situation. True, there are countries in which Western alliance is foisted on the people by unpopular government; however, there are others who are genuinely anti-Communist from bitter experience and who desire an American guarantee.

For some countries, unfortunately, there are not always truly independent neutralist alternatives. Moreover, a replacement of a Western alliance by neutrality does not necessarily mean a reduction in the extent of American commitments. The United States cannot afford, even in such cases, to really wash its hands of countries that show a will to maintain their independence. The crux of the matter, says Lowenthal, is that dependence upon the formal military pacts alone is not the answer. The third position that he defines, which is his own and currently a dominant one in the United States, "maintains the American world-wide commitment to back popular resistance to Communism in any part of the globe. It accepts the lessons of Cuba and Laos that where such resistance is lacking, it cannot be replaced by military intervention from outside; and it leaves to those nations that wish to maintain their independence the free choice of whether they regard neutrality or an alliance with the U.S. as the best way to do so. At the same time, it offers every kind of support for such nations —from advice and funds for solving their social problems by progressive policies to military aid (and even direct military backing) against Communist diplomatic blackmail or guerrilla warfare fomented from outside. Its general maxim is to help all those who are willing to help and defend themselves." (p. 67)

It would seem that Lowenthal has some fairly important support in the current administration. Lowenthal's general interpretation of Khrushchev's policies as being more revolutionary than Stalin's, and his insistence that Khrushchev's recent aggressiveness is not the result of pressure by the Chinese or by die-hards in the Kremlin, but rather, of his own persistent belief in world revolution, predictably invoke considerable opposition among those quarters in England that still consider Khrushchev much closer to Peter the Great than to Lenin. To his opponents' criticism of his view as unnecessarily nihilistic, Lowenthal replies that although he sees Mr. Khrushchev as wishing to achieve world domination, he also sees him as wishing to avoid world war. And although much negotiation with the Soviets will be futile, an effort to limit the military risks of a conflict is all the more urgent and by no means hopeless.

In the March issue of *Encounter*, Theodore Draper wrote an article entitled "Castro's Cuba" which Walter Lippmann called "the most informative and illuminating thing I have read [on the subject]." (*Encounter*, June, 1961, p. 96) Even Herbert Matthews of *The New York Times*, whose position has generally been less stern than Draper's, said this in a letter to *Encounter*: "I admired Ted Draper's article very much in your March *Encounter*. It is rare, although not so rare in Europe as it is here, to see a dispas-

sionate and cogent analysis of that very emotional and irrational event which is the Cuban Revolution." (*Encounter*, May, 1961, p. 95) Matthews' main reservation was that, in his estimation, Draper tried to draw too much order out of disorder. Matthews continues to maintain that there was a time when the United States could have kept Castro from placing his revolution in Communist hands, principally by supporting him in its early stages. We erred, in Matthews' view, due to an overestimation of the strength of the Cuban middle class and an underestimation of the power and misery of the lower classes. As Matthews says later in his letter,

"This does not mean that I approve of what Fidel Castro and his government are doing or that I ignore the fact that he is the most formidable enemy of the United States who has ever appeared in our hemisphere. I am also profoundly disappointed that the dynamism of his revolution and the conflict with the United States should have induced him to place his revolution in the Communist hands. I do not mean that his revolution is Communist, but it is on the side of Communism, and it is now totalitarian." (p. 96)

Draper's original article "Castro's Cuba" is truly a remarkable performance. He first deals with the Castro apologists, Jean-Paul Sartre, Simone de Beauvoir, Leo Huberman, and Paul M. Sweezey (editors of *Monthly Review*) and C. Wright Mills, author of the popular *Listen, Yankee.* He makes passing comments also on Paul Johnson of the *New Statesman* and Professor Samuel Shapiro, writing in the *New Republic.* Incidentally, he considers Herbert Matthews, *The New York Times* reporter, in an entirely different category from these apologists, although he disagrees with Matthews' later belief that Castro is more a victim of Fidelismo than its perpetrator.

In recounting the history of the revolution, Draper points out that, far from its being a peasant revolution occurring in an essentially rural country, it broke out in one of the most middle-class countries in Latin America. As a matter of fact, Cuba was more urban than rural at the time of the revolution —57 per cent of the population was in urban areas, and 43 per cent in rural, and although the standard of living was low by U. S. and West European standards, it was comparatively high by Latin American. He does point out, however, that Cuba's economy was not a healthy one and that it did have serious social problems, due partly to the indifference of Cuban upper- and middle-classes toward the welfare of the land workers. He finds that C. Wright Mills was right at least in pointing out that it was a revolution largely of a few middle-class students and intellectuals. Eighty-two men invaded Cuba with Castro in December, 1956, and twelve survived to fight in the Sierra Maestra; they all came from the middle class. Castro himself is the son of a rich land owner, a university graduate, and a lawyer. It was only in the mountains that these student revolutionaries had their first face-to-face encounter with the crying poverty, illiteracy, disease, and primitivism of the outcast peasants.

From this, says Draper, came the determination to revolutionize the Cuban society by raising this lowest, neglected sector. Castro's forces in the mountains, however, were always too small to even consider overthrowing

Batista by arms. A general strike, a part of larger resistance movements in the cities by the middle class, was to be the method. The strike, however, failed because the organized urban workers were doing well under Batista. In addition, the Communists sabotaged the strike because they were not included in the movement. When the general strike failed, Castro shifted to full-scale guerrilla warfare, in spite of the fact that the entire forces of Castro (the "Barbudos," or the "Bearded Ones") in the mountains never numbered more than about 3,000 from beginning to end, whereas Batista's army was over 40,000 and well armed.

Castro's guerrilla tactics then were not aimed so much at defeating the enemy as at inducing him to lose his head, which Batista promptly did. As Draper described it:

"The Army and Secret Police struck back blindly, indiscriminately, senselessly. The students, blamed as the main trouble makers, were their chief victims. It became safer for young men to take to the hills than to walk in the streets. The orgy of murders, tortures and brutalities sent tremors of fear and horror through the entire Cuban people and especially the middle-class parents of the middle-class students." (p. 8 in *The New Leader* supplement)

The general revulsion, however, eventually permeated the army itself, and Batista's army just evaporated. As Draper points out, the heaviest losses were suffered by the middle-class urbanites, and the real victor in this historic struggle was the entire Cuban people. At this time the revolution that Castro had promised was the restoration of the 1940 Constitution, with a guarantee of general elections at the end of one year and an absolute guarantee of freedom of information, press, and all individual and political rights. He specifically maintained that he had no thought of replacing military dictatorship with revolutionary dictatorship. As he said, he intended to lead the country to full constitutional and democratic procedures. From 1953 through 1958, Castro's stated economic aims provided for grants of land to small planters and peasants, with indemnification to the former owners, the right of workers to share in profits, a greater share of the cane crop to all planters, and confiscation of illegally obtained property. He advocated maximum holdings for agricultural enterprises and a distribution of remain-

**SCIENCE AND THE MILITARY**

*Oliver Austin, Jr.*, BIRDS OF THE WORLD (Golden Pr.)

*John C. Bennett (ed.)*, NUCLEAR WEAPONS AND THE CONFLICT OF CONSCIENCE (Scribners)

*Otto O. Binder*, VICTORY IN SPACE (Walker)

*Ronald W. Clark*, THE BIRTH OF THE BOMB: THE UNTOLD STORY (Horizon)

*Harry L. Coles*, TOTAL WAR AND COLD WAR: PROBLEMS IN CIVILIAN CONTROL OF THE MILITARY (Ohio State Univ.)

*Giorgio De Santillana*, THE ORIGINS OF SCIENTIFIC THOUGHT (Univ. of Chicago)

*J. S. Dupre and S. A. Lakoff*, SCIENCE AND THE NATION: POLICY AND POLITICS (Praeger)

*Maj.-Gen. J. F. C. Fuller*, THE CONDUCT OF WAR, 1789-1960 (Rutgers)

*Roy R. Grinker, M.D.*, PSYCHOSOMATIC RESEARCH (Grove)

*Irving D. Harris, M.D.*, EMOTIONAL BLOCKS TO LEARNING (Free Pr.)

*Capt. J. W. Kittinger, Jr., and Martin Caidin*, THE LONG LONELY LEAP (Dutton)

*Walter Lord*, A TIME TO STAND: THE EPIC OF THE ALAMO SEEN AS A GREAT NATIONAL EXPERIENCE (Harper)

*Donald N. Michael*, PROPOSED STUDIES ON THE IMPLICATIONS OF PEACEFUL SPACE ACTIVITIES FOR HUMAN AFFAIRS (Brookings Inst.)

*Peter Paret and John Shy*, THEORY OF GUERILLA WARFARE (Praeger)

*Peter Ritner*, THE SOCIETY OF SPACE (Macmillan)

*Daniel E. Sheer*, ELECTRICAL STIMULATION OF THE BRAIN: AN INTERDISCIPLINARY SURVEY OF NEUROBEHAVIORAL INTEGRATIVE SYSTEMS (Univ. of Tex.)

*Henry E. Sigerist*, A HISTORY OF MEDICINE (Early Greek, Hindu, and Persian medicine; Oxford)

*Morris I. Stein (ed.)*, CONTEMPORARY PSYCHOTHERAPIES (Free Pr.)

*Stephen Toulmin*, FORESIGHT AND UNDERSTANDING: AN ENQUIRY INTO THE AIMS OF SCIENCE (Ind. Univ.)

*F. E. Trinklein and C. M. Huffer*, MODERN SPACE SCIENCE (Holt)

*B. L. Van Der Waerden*, SCIENCE AWAKENING (Egyptian, Babylonian, and Greek math.; Oxford)

*Sherwood L. Washburn*, SOCIAL LIFE OF EARLY MAN (Quadrangle)

*Herbert Wendt*, IT BEGAN IN BABEL (Birth of people, races, and cultures; Houghton)

ing land to farming families; he proposed to encourage agricultural co-operatives for the common use of costly equipment, cold storage plants, and a single professional technical direction in cultivation and breeding.

An early speech mentioned the nationalizing of the electric and telephone companies, although he later denied in a *Coronet* article that he intended to extend the government ownership to public utilities, and called nationalization a cumbersome instrument. He declared he had no plans for expropriating or nationalizing foreign investments. It was, says Draper, this revolution based on the 1940 Constitution that was the basis of Castro's victory in January, 1959, and it was this revolution that Castro unquestionably betrayed later by wholesale confiscation and socialization, state farms and co-operatives, and a wholly government-controlled press. Draper caustically criticizes the apologists' literature on Cuba, especially *Listen, Yankee* by C. Wright Mills. He concedes that Mills' book is in one way peculiarly useful in that it records the actual conversations of Castro leaders. He says "Anyone who wants to get the Castro party line most nakedly can get it here." (p. 5)

He continues, however, to say that "A reader has a right to expect that the author should do some work of his own beyond listening only to one side, and that a sociologist would at least be able to give a reasonably accurate report of the social structure of the country." (pp. 5-6) Considering the opposite extreme from the Castro apologists, he castigates *Red Star Over Cuba* by Nathaniel Weyl. As he says, there is no indication that Weyl has had any personal knowledge of Cuba in the last two years or at any other time. He adds, "The recklessness with which Weyl uses his materials, good, bad and dubious, is matched by that of his views." (p. 18) He then proceeds to show the inconsistencies, the distortions, and plain erroneous data throughout the book. As he concludes on page 20, "Every bit of evidence that would not fit the book's thesis is ruthlessly suppressed or glossed over. All the hard problems of Castro's political development are over-simplified and vulgarized."

Nor does Draper completely absolve Weyl's chief American target, Herbert L. Matthews of *The New York Times.* But Draper's main point of difference with Matthews is on whether Castro was the architect or the dupe of Fidelismo. Draper him-

FOR THE BUSINESS EXECUTIVE

*William L. Baldwin,* ANTITRUST AND THE CHANGING CORPORATION (Duke)

COMPANY PARTICIPATION IN THE POLITICAL PROCESS (Nat'l Ind. Conf. B'd)

*Raymond J. Corsini and others,* ROLE-PLAYING IN BUSINESS AND INDUSTRY (Free Pr.)

DEFENSE MARKETING IN THE 1960's (A.M.A.)

*Paul M. Dodyk,* THEORIES OF CORPORATE POWER (Amherst Coll.)

*Mortimer Feuer,* PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS (Prentice)

*Thomas W. Harrell,* MANAGERS' PERFORMANCE AND PERSONALITY (Southwestern)

*George C. Houston,* MANAGER DEVELOPMENT: PRINCIPLES AND PERSPECTIVES (Irwin)

*Guy Hunter,* STUDIES IN MANAGEMENT (Univ. of London)

*Joseph C. Kennedy,* CORPORATE TRUST ADMINISTRATION (N. Y. Univ.)

*Dana Latham,* MANAGEMENT'S STAKE IN TAX ADMINISTRATION (Tax Inst.)

*Rensis Likert,* NEW PATTERNS OF MANAGEMENT (McGraw)

*James F. Lincoln,* A NEW APPROACH TO INDUSTRIAL ECONOMICS (By head of Lincoln Electric Co., Cleveland; Devin-Adair)

*Gardiner Means,* PRICING POWER AND THE PUBLIC INTEREST (Harper)

*Robert E. Moore,* THE HUMAN SIDE OF SUCCESSFUL COMMUNICATION (Prentice)

*George S. Odiorne,* HOW MANAGERS MAKE THINGS HAPPEN (Prentice)

*Thomas F. Patton,* BUSINESS SURVIVAL IN THE SIXTIES (Harper)

*Herbert Read,* ART AND INDUSTRY (Ind. Univ.)

*James E. Redfield,* A STUDY OF MANAGEMENT SERVICES BY CERTIFIED PUBLIC ACCOUNTANTS (Univ. of Tex.)

*Richard H. Rush,* ART AS AN INVESTMENT (Prentice)

SHAPING A NEW CONCEPT OF ADMINISTRATIVE MANAGEMENT (A.M.A.)

*Nathan Shefferman with Dale Kramer,* THE MAN IN THE MIDDLE (Doubleday)

*William F. Whyte,* MEN AT WORK (Irwin)

*Rosamond Young,* BOSS KET: A LIFE OF CHARLES F. KETTERING (Longmans)

*Harmon Zeigler, Jr.,* POLITICS OF SMALL BUSINESS (Pub. Affairs Pr.)

## NATIONAL ISSUES

*Richard Barnett,* WHERE THE STATES STAND ON CIVIL RIGHTS (Bold Face Book)

*Alan Barth,* THE PRICE OF LIBERTY (Police violation of personal liberty; Viking)

*Harry A. Bullis,* MANIFESTO FOR AMERICANS (Businessman's call to arms; McGraw)

*J. I. Coffey and V. P. Rock,* THE PRESIDENTIAL STAFF (Nat'l Planning Ass'n)

DISTRESSED AREAS IN A GROWING ECONOMY: A STATEMENT ON NATIONAL POLICY (Com. for Econ. Dev.)

*Robert A. Dahl,* WHO GOVERNS? DEMOCRACY AND POWER IN AN AMERICAN CITY (Yale)

*Hawthorne Daniel,* PUBLIC LIBRARIES FOR EVERYONE (Doubleday)

*Dwight L. Dumond,* ANTISLAVERY: THE CRUSADE FOR FREEDOM IN AMERICA (Univ. of Mich.)

*E. R. Ellis and G. N. Allen,* TRAITOR WITHIN: OUR SUICIDE PROBLEM (Doubleday)

*Milton J. Esman,* NEEDED: AN EDUCATION AND RESEARCH BASE TO SUPPORT AMERICA'S EXPANDED COMMITMENT OVERSEAS (Univ. of Pitt.)

*David Farnsworth,* THE SENATE COMMITTEE ON FOREIGN RELATIONS (Univ. of Ill.)

*Judith Friedberg,* THE NEW FRONTIERSMEN (Kennedy gov't; Appleton)

*Art Gallagher, Jr.,* PLAINVILLE FIFTEEN YEARS LATER (Follow-up of 40's sociological study of Mo. farming community; Columbia)

*Nathan Glazer,* THE SOCIAL BASIS OF AMERICAN COMMUNISM (Harcourt)

*John Herling,* THE GREAT PRICE CONSPIRACY (On electrical companies case; Robert B. Luce)

*Jane Jacobs,* DEATH AND LIFE OF GREAT AMERICAN CITIES (Ed. of *Arch. Forum* on city planning; Random)

*John A. Kouwenhoven,* THE BEER CAN BY THE HIGHWAY (American culture study; Doubleday)

*Dan Lacy,* FREEDOM AND COMMUNICATIONS (Univ. of Ill.)

*Robert Lekachman (ed.),* NATIONAL POLICY FOR ECONOMIC WELFARE AT HOME AND ABROAD (Russell & Russell)

*R. K. Merton, Robert King, and R. A. Nisbet (eds.),* CONTEMPORARY SOCIAL PROBLEMS (Harcourt)

*Newton N. Minow and others,* FREEDOM AND RESPONSIBILITY IN BROADCASTING (Northwestern)

*NBC News Correspondents,* MEMO TO JFK (Putnam)

*Virgil M. Newton,* CRUSADE FOR DEMOCRACY (On gov't corruption; Iowa St. Univ.)

*Terrence O'Flaherty,* THE ILLUSTRATED AIR (on TV; Appleton)

*Stan Opotowsky,* THE KENNEDY GOVERNMENT (Dutton)

*J. W. Peltason,* FIFTY-EIGHT LONELY MEN: SOUTHERN FEDERAL JUDGES AND SCHOOL DESEGREGATION (Harcourt)

*Rockefeller Bros. Fund.,* THE POWER OF THE DEMOCRATIC IDEA (Doubleday)

*P. H. Rossi and R. A. Dentler,* POLITICS OF URBAN RENEWAL: THE CHICAGO FINDINGS (Free Pr.)

*Dean Rusk,* ROLE OF THE FOUNDATION IN AMERICAN LIFE (Claremont Coll.)

*John Scarne,* SCARNE'S COMPLETE GUIDE TO GAMBLING (On U.S. gambling; S. & S.)

*Stephen C. Shadegg,* BARRY GOLDWATER: FREEDOM IS HIS FLIGHT PLAN (By campaign manager; Fleet)

*A. Robert Smith,* WAYNE MORSE: THE TIGER IN THE SENATE (Doubleday)

*Dan Throop Smith,* FEDERAL TAX REFORM: THE ISSUES AND A PROGRAM (McGraw)

*H. M. and A. R. Somers,* DOCTORS, PATIENTS, AND HEALTH INSURANCE (Brookings Inst.)

*Andrew Tully,* CIA: THE INSIDE STORY (Morrow)

*Jerry Voorhis,* AMERICAN COOPERATIVES: WHERE THEY CAME FROM, WHAT THEY DO, WHERE THEY ARE GOING (Harper)

*Dick S. West,* THE BACKSIDE OF WASHINGTON (Doubleday)

*C. F. Westoff and others,* FAMILY GROWTH IN METROPOLITAN AMERICA (Princeton)

*Aaron Wildavsky,* DIXON-YATES: A STUDY IN POWER POLITICS (Yale)

## FOR LEISURE

*Eugene Fodor,* FODOR'S GUIDE TO JAPAN AND EAST ASIA (McKay)

*Peter Helck,* THE CHECKERED FLAG (Scribners)

*Richard Hough,* A HISTORY OF THE WORLD'S SPORTS CARS (Harper)

*Geoffrey Johns,* WHAT AM I BID? (By Eng. antique dealer; Doubleday)

*Alexander Laing,* AMERICAN SAIL (Pictorial hist.; Dutton)

*Arthur Liebers,* ENCYCLOPEDIA OF PLEASURE BOATING (Barnes)

*William E. Massee,* WINES AND SPIRITS (McGraw)

*Jack O'Connor,* THE BIG GAME ANIMALS OF NORTH AMERICA (Dutton)

*Louis T. Stanley,* THE GRAND PRIX YEAR (Barnes)

*Alice Winchester (ed.),* COLLECTORS AND COLLECTIONS (Dutton)

self leaves no doubt that in his opinion it is the ego of Fidel Castro himself that is the *bête noire*. The democratic revolution based upon the 1940 Constitution would unfortunately reduce Castro to an elected official at best, whereas now the dictatorship of the proletariat revolution or the peasant revolution, as it is sometimes called, affords Castro the power that he seeks. Draper feels that in the end Fidel's ego may give the Communists as much trouble as it has given some of the others. As for the Communists, he says, "For the Communists and the Fidelistas to meet, *both* had to travel some distance from their starting-points. The Communists had to make up their minds that they could win power, not against Fidel but only through Fidel." (p. 26)

In reply to his British critics, the most vocal of whom have been writers in the *New Statesman* and *Time and Tide*, Draper, in a second article entitled "Cubans and Americans" in the July *Encounter*,[3] quotes with some satisfaction from the *New Statesman*'s correspondent (December 20, 1958),

"'Fidel Castro is as opportunistic as Batista. Three years ago, when he first revolted against Batista, he put forward a left-wing programme, which included nationalisation of key industries and an agrarian reform. But this did not catch on, and soon Castro drifted into the extreme right, where bankers and land-owners were willing to finance his revolution—if only to get rid of Batista. Castro accepted, and for a few months his was probably the most luxurious revolutionary movement ever.'" (p. 76)

Since one of Draper's points in his original article had been that Castro cannot be overthrown except by force (just as there was no other way to overthrow Batista), he felt bound to clarify his views after last April's disastrous fiasco in the Bay of Pigs. Thus in his second article, Draper reviews the history of that invasion before he makes his point that this was not quite what he meant when he advocated or predicted eventual armed overthrow of Castro. As he says on page 59, "There were two sides to the failure, Cuban exile politics and United States policy."

He points out that the early Cuban exiles (early 1959) were followers of Batista, completely discredited at home, morally and politically. It was at this time (April, 1959) that Castro spent three hours in a conference with Nixon in Washington. As a result of this conference, Nixon wrote a three-page memorandum. The text of the memorandum has never been published, but it is known, says Draper, that during his conversation with Castro, Nixon became convinced that Castro, while not a Communist, was at least a captive of the Communists; Nixon consequently advocated training guerrilla forces to overthrow Castro. Such guerrilla forces in the spring or summer of 1959, however, would have had to be composed almost exclusively of ex-Batista officers and soldiers. Says Draper, "One can only marvel at this proposal of April, 1959. If Fidel Castro wanted the United States to do anything, it was to ally itself with the *Batistianos* in its midst." (p. 60) Nixon's recommendation, however, was rejected.

The real turning point in the revolution occurred in the fall of 1959, and was marked by the arrest of the school teacher Hubert Matos. Matos had risen to the highest rank, major, in the rebellion, and was entrusted with the military leadership of one of the provinces. In the spring of 1959, he began to question why Communists were being put into leading positions in provincial and town administrations at the expense of "26th of July" members. When the futility of his protests to Castro became apparent, he sent in his resignation on October 19. Because of the increasing Communist take-over of the province, a majority of the army leaders in his province resigned with him. Matos was arrested at home on October 20, and Castro rushed to the province to crack down on the dissenters. When Matos was finally charged with treason, disaffection appeared all up and down the line. Matos was condemned to 20 years imprisonment, and in February, 1960, the president of the official Cuban Communist party publicly equated anti-Communism with treason. (When such equating was refuted by a radio commentator whose political and personal ties to Castro had been extremely close, Castro himself devoted a four-hour television program to ridiculing, insulting, and denouncing him. The radio commentator fled.)

"These were episodes in what had become, for Fidel Castro, a second

[3] By special arrangement with *Encounter*, Theodore Draper's two articles were reprinted in this country as supplements to the weekly *The New Leader*: "Castro's Cuba: A Revolution Betrayed?" (March 27, 1961) and "Cuba and U.S. Policy" (June 5, 1961). Draper, incidentally, was the author of *The Roots of American Communism* and *American Communism and Soviet Russia*.

civil war. In the first, he had represented a democratic cause, and it had required a civil war against Bastista's dictatorship. In the second, he represented a totalitarian alliance with the Communists, and it required a civil war against the democratic elements in his own movement. Castro waged the second civil war as ruthlessly as the first, striking down all those who stood in his way and leaving them only the alternatives of following him blindly or fighting back in a second underground." (p. 62)

The main exodus then of Cuban exiles started in the spring of 1960, speeded up in the summer, and became a mass flight by the end of 1960. By 1961 over 100,000 political emigrés had gathered in the United States. By the spring of 1960, the Eisenhower administration had made the decision to support an invasion force. The first problem was with which Cubans to work. Too many of the Cuban exile politicians of the right and center were content to accept the dictation of the CIA, just as the CIA was content to dictate to them. In some cases, these politicians were free of any of the Batista taint, but their own past identified them with régimes corrupt enough to prepare the way for Batista. They were therefore hardly appropriate symbols of the new Cuba, which was determined to get something better than Batista or his predecessor. The main difficulty seemed to be, says Draper, that the Eisenhower policy needed Cuban exiles who had not been compromised by anything very different from the pre-Batista régimes (little better sometimes than Batista). The influx of emigrés by the end of 1960, however, made the left a serious rival of the right and center within the Cuban emigration group. In talking about the dissensions between the different groups of emigrés, Draper makes the point that whatever Castro's personal intentions, the revolution at least was professedly anti-Communistic in its early phases. In fact, the overwhelming majority of Cubans of all classes were admittedly pro-Castro in January of 1959. Therefore, the tendency of the earlier emigrés (of the right) to brand all the later emigrés as *ipso facto* Communists was hardly tenable. This struggle had another facet, which was the crucial practical question of whether the underground in Cuba or the exiles in the United States should constitute the primary force in the struggle against Castro.

"For some, the underground came first, and the role of the exiles was mainly to assist and support it. For others, the exiles came first, and the underground had virtually no place in their plans. This choice between the underground and the exiles was one of the chief dividing-lines between the Left and the Right. The Left invariably stressed the underground, and the Right was almost exclusively in favor of the exiles, and there were elements of the Centre in both camps." (p. 65)

On May 1, 1959, Fidel had distinguished his revolution from both capitalism and Communism: from the first, because it killed people with hunger, and from the second, because it repressed their liberties. Moreover, the general and wholesale nationalization that took place in the summer and fall of 1960 was unanticipated by the Cuban press in general and by many in the régime. At the same time, the rapprochement between Castro's régime and Russia became more overt. With the advent of the new American administration in 1961, there was a policy shift from favoring the center among the exiles to the left. And in March the Cuban Revolutionary Council, headed by Cardona, was instituted. This was reflected in the State Department's White Paper on Cuba:

" 'The challenge results from the fact that the leaders of the revolutionary régime betrayed their own revolution, delivered that revolution into the hands of powers alien to the hemisphere, and transformed it into an instrument employed with calculated effect to suppress the re-kindled hopes of the Cuban people for democracy and to intervene in the internal affairs of other American Republics.' " (p. 70)

The two main groups within the council on March 22 had formulated some basis for unity and published a statement on the insurrectional struggle to come. The first proviso was that priority should be given to those fighting inside Cuba against the Communist oppressor. Second, no persons who had been associated responsibly with Batista were to have any participation in the struggle. Third, the military command was to be in the hands of Cubans and answerable to the president of the council. And fourth, these criteria were to fully prevail in the forces that were being organized. Meanwhile, the shipments of arms by the Soviets introduced a problem of time, and because of this the role of the Cuban Revolutionary Council was undermined by the holdovers of the older policy.

"Maximum priority was given to the outside invasion force, not to the un-

derground in Cuba. Objectionable personnel were admitted and not weeded out of the invasion force. The Council was not in command of the situation, and its members were humiliated by those who were.

"On the surface, two different lines were pursued simultaneously, one for the Revolutionary Council, another for the invasion force. The former implied that some re-examination had taken place in the Kennedy administration; the latter amounted to an expression of modified Nixonism. The difference between these two lines is the key to what was wrong with the conception, as well as the execution, of this invasion." (p. 73)

Because the anti-Castro forces inside Cuba were virtually ignored, the invasion came as a surprise. Further, it discouraged the anti-Castro forces inside from doing anything because it was too small and, having the full backing of the United States, was not popular. Despite this failure, which he calls "perfect" because so complete, Draper says that

"Castro's democratic opponents have the right and the duty to obtain arms where they can, as Castro did and as other revolutionary movements have done. The United States can help, but a democratic Cuban opposition worthy of the name will accept arms or other assistance only on its own terms. Whatever the United States or any other power does or does not do must influence the situation in Cuba; the United States could remove its influence only by disappearing. Some forms of 'non-intervention' are nothing more than acquiescence in someone else's intervention, and some forms of 'intervention' are so wrong and futile that they amount in their practical effect to non-intervention." (p. 77)

Throughout, Draper's documentation is impressive and his conclusions compelling.

One new book seems relevant enough to warrant consideration before returning to our magazine article survey.

**Robert S. Smith** in **THE UNITED STATES AND CUBA: BUSINESS AND DIPLOMACY, 1917-1960** (Bookman Associates, $5.00) finds too many of the recent works stressing only the political side of foreign policy and rigidly segregating it from the economic. As he states in the preface,

"This study is designed to develop the economic aspects of Cuban-American relations, and to show their relationship to diplomacy. If these at times seem to emerge as dominant elements, it is only because the State Department documents lead the way. Economic motives and pressures are not the only elements in the story, and there is nothing deterministic about the role of business in diplomacy. Diplomatic historians, however, have overdone the 'ivory tower,' 'chessboard' approach to foreign policy. I have chosen to approach the subject from the standpoint of the market place and the political arena." (p. 10)

There is ample proof that Dr. Smith, a history professor at Texas Lutheran College, has indeed made use of material from the State Department archives. He quotes, for example, from some Department of State memoranda used as the basis of a Stimson speech in 1930:

" 'Irrespective of the policy at Washington and the personality of statesmen, the operations of such enterprises

### "HOW-TO" READING

*William J. Baxter,* HOW TO MAKE MONEY THAT YOU CAN KEEP (Internat'l Econ. Res. Bur.)

*William J. Casey,* TRUST MANUAL AND GUIDE (Inst. for Bus. Planning)

*Michael Fidlow,* HOW TO STRENGTHEN YOUR MEMORY (Sterling)

*H. W. Gabriel,* TECHNIQUES OF CREATIVE THINKING FOR MANAGEMENT (Prentice)

*William J. Gordon,* SYNECTICS: THE DEVELOPMENT OF CREATIVE CAPACITY (Harper)

*Peter Hilton,* HANDBOOK OF NEW PRODUCT DEVELOPMENT (Prentice)

*Huskey and Korn,* COMPUTER HANDBOOK (McGraw)

*Helen K. Knowles,* HOW GROUPS RAISE FUNDS (Bond Wheelwright)

*Raymond Lesiker,* REPORT WRITING FOR BUSINESS (Irwin)

*Robert T. Oliver,* CONVERSATION: THE ART AND TRAINING OF EFFECTIVE SPEECH (Thomas)

*Donald Owen,* HANDBOOK OF STATISTICAL TABLES (Addison)

*Jerry S. Reisman,* STYLE MANUAL FOR TECHNICAL WRITERS (Macmillan)

*Hugo Rothchild,* HOW TO MAKE MONEY IN REAL ESTATE SYNDICATES (Syndicate Books, 350 Broadway, N. Y. 13)

*M. Schiller,* FORTUNES IN SPECIAL SITUATIONS IN THE STOCK MARKET (Citadel)

*Geneva Seybold,* PERSONNEL PROCEDURE MANUALS: THEIR CONTENTS, FORMAT, PREPARATION AND DISTRIBUTION (Nat'l Indust. Conf., 460 Park Ave., N. Y.)

*Clayton A. Umbach, Jr.,* HOW TO PREPARE FOR MANAGEMENT RESPONSIBILITIES (Gulf Pub.)

*Yeck and Maguire,* PLANNING AND CREATING BETTER DIRECT MAIL (McGraw)

*Zetler and Crotch,* SUCCESSFUL COMMUNICATION IN SCIENCE AND INDUSTRY: WRITING, READING AND SPEAKING (McGraw)

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as the United Fruit Company or the several American oil companies create independent political interests in the territories subject to their economic operations, which supplement and often determine official policy both at Washington and in the various Latin American capitals.'" (p. 8)

Smith sees this attitude as natural in a country like the United States where private business enterprises are a major concern of the nation, and where almost all the citizens are connected with some aspect of that economic system. Nor does he see it due simply to business pressure. This does exist, but often business interests conflict with each other. Principally, though, government officials share the economic views of certain groups and shape such policies without undue pressure. In fact, some of the officials have been in business before entering government service, and others have social and educational ties with business leaders. Nor does he see anything wrong in America's having overseas business interests. As a large industrial nation we have no alternative. And in fact these interests often play a valuable role in the economy of other areas. But we cannot afford to overlook the point that conflict will develop between economic interests and the national ideal of self-determination. Too often we tend to opt for the *status quo* without trying to formulate alternative policies that in the long run will be more to our advantage.

It is just such conflict that Smith reports throughout his book, starting with the Platt Amendment in 1898 and ending with Castro. In light of the concepts of international morality in 1961, most of it makes fairly sad reading. If, for example, we were to read the terms of the Platt Amendment as between the Soviet Union and Afghanistan in 1961, instead of as between the United States and Cuba in 1898, we might better understand the Cuban revolutionaries. To put it more concretely, suppose the Soviet Union imposed a treaty upon Afghanistan which stated: (1) that the Soviet Union could approve the Afghanistan national budget; (2) that the Soviet Union be granted the right to intervene for the preservation of Afghanistan's independence and the maintenance of a government adequate to the protection of life, property, and individual liberty; (3) that all Soviet Union acts in Afghanistan during its military occupancy there be ratified and protected; and (4) that the Soviet Union have the right to lease any land necessary for military establishments to protect that independence. We would be among the first to assert that Afghanistan was a new Russian satellite. (Indeed, "protectorate" long ago became synonymous with "colony.") We must reluctantly recognize the similarity between this hypothetical situation and the U.S.-Cuba relationship under the Platt Amendment.

From 1898 to World War II, the United States applied the Platt Amendment and its terms very consistently, backing them up where necessary with U.S. Marines. What we consistently protected, moreover, were not the interests of the Cuban people, but our own economic interests in that island. Since the climate of world opinion is somewhat different in 1960 than it was in 1900, we tend to deny the hard facts or to doctor them by sophistical rationalization instead of facing them and going on from there. The future of international business itself will depend upon adjustment to just such hard facts rather than to wishful thinking. Our marketers abroad are going to have to continue to face accumulated ill will due to the former excesses of our extractive industries abroad.

At the conclusion of this international business history, Smith states:

"In the long-range perspective of United States policy the emphasis has been placed on order, stability, and the protection of American interests. This has meant that the United States has generally opposed sweeping economic reforms, and Cuban nationalism —except that of the Machado and Batista variety. From the 1890's to the present, the United States has supported the conservative upper classes and their American allies. The history of Cuban-American relations testifies to the consistency of this policy.

"This is only one segment of American foreign policy. The United States stress on order and the protection of American interests has been part of a larger world-view held by statesmen in the twentieth century. . . . There is nothing wrong with doing business abroad, but in our push into 'new frontiers' we have all too often believed that our interests were synonymous with what was best for other countries.

This helps to explain why the United States has in many cases been unsympathetic to the nationalistic programs of underdeveloped nations. Their attempts to solve their peculiar problems have often conflicted with our definition of correct economic and political practices. Thus, the United States has tended to oppose change when it seemed to threaten some alteration in American economic interests. . . . To adhere to our traditional definition of order, stability, and protection of American interests, and to demand that these struggling nations conform to our policy is to court disaster in the cold war." (pp. 183-85)

His solution he gives in his preface:

"Any alternative to Communist influence will involve sacrifices on the part of all Americans: businessmen with overseas interests and average citizens. Admiral Hyman Rickover has written: 'No democratic nation can successfully pursue its international objectives unless its people are willing to subordinate private interest to national interest in all areas where the country's world position is at stake.' The future of freedom is at stake in the underdeveloped nations today, and the national interest will require such subordination to private interests. If this study seems critical of the policy of the United States, it is only because the exaltation of private interests in the past has in some measure contributed to the crisis of freedom in the underdeveloped areas of the world." (p. 11)

This book serves a useful purpose. The age-old appeal of the Cinderella story goes far to explain the Castro magic in much of Latin America. Who can help rejoicing when the poor slavey makes the ball despite all the efforts of a wicked stepmother and stepsisters? At least this is how it seems to the have-nots. Smith, while not rationalizing in the stepmother's favor, does manage to show her somewhat as a creature of her age, more myopic than wicked.[4]

Richard N. Rosecrance in "Categories, Concepts, and Reasoning in the Study of International Relations" in the July, 1961 issue of *Behavioral Science* argues for an entirely different approach toward the study of international relations. He says that instead of trying to bring everlasting order out of chaos, it might be better to delineate the conditions of chaos itself, using precise conceptual tools. To him, such tools are better and more precise definitions. As he says:

"Protean terms make investigation difficult; we must always be sure what sense we are using, and we must make sure that arguments which we formulate in terms of the single use of a term are not extended to a second use without careful reinvestigation. Where there is a shifting balance of concept and reality, the invitation to inconsistency is difficult to resist." (pp. 230-31)

He illustrates this by means of the term "power," which he feels is integral to international relations, but which is so variously employed as to be almost useless for close reasoning. He suggests that narrow operational definitions would facilitate our understanding of the international world and that only a recurrent attending to the empirical can offset the excess of theory. A satisfactory balance between what is conceptual and what is concrete must be established. This article is interesting especially as a sample of the author's forthcoming *Empirical Systems of International Relations.*

Paradoxically, at the same time that Rosecrance is advocating a change in the study of international relations from large-scale theories to particulars, Sydney C. and Beatrice K. Rome in the April issue of *Behavioral Science* are starting a series of investigations into large social groups, which they call Leviathan Studies. This is an attempt to build some small-group analysis into the kind of group theory that will be applicable to the working of a complex organization. (This size, even so, is far from that of an international organization, which stretches the concept of "complex" almost out of reason.) The article is entitled "The Leviathan Technique for Large-Group Analysis" and is described as an interim report. Starting with the assumption that large groups are functionally and structurally different from face-to-face groups, and that present mathematical formulations of social processes are inadequate to provide analytic predictive control over such multilevel processes, the authors spell

[4] In the October *Current* the following articles are summarized: *The U.S., Cuba, and Latin America* by Jaimé Benitez, Chancellor of the University of Puerto Rico (Fund for the Republic); "A Plan for Revolution in Latin America" by Peter Drucker *(Harper's Magazine,* July, 1961); "The Land Reform Issue in Latin America" by Thomas F. Carroll *(Latin American Issues,* Twentieth Century Fund); and "Castro and the Communists" by Ernst Halperin *(The New Republic,* Aug. 21, 1961). *The Economist* (April 22, 1961, pp. 319-40) ran an excellent section entitled "Latin American Future."

out their intention to develop a new technique.

"This technique combines two facets, first, a hypothetico-deductive formulation in terms of general rules, and second, a logical, analogue simulation on a large digital computing machine. On the computer we can obtain precise systemic consequences of various constellations of general social rules. In the remainder of the present paper, we shall describe broad aspects of our computer formulations." (p. 149)

After describing the computer formulations, they state that they expect to have facilities for introducing perhaps eight or more live decision-makers, who will actively intervene with the computers in the roles of intermediate executives or of top management while their experiments are performed. They discuss briefly the problems involved and their hopeful solutions.

Also in the July issue of *Behavioral Science*, Richard L. Meier of Michigan's Mental Health Research Institute continues his series called "Explorations in the Realm of Organization Theory." This particular study, the fourth, is called "The Simulation of Social Organization." He starts by discussing the difficulty of simulation of this sort—the construction of a system that closely approximates what has been observed in the real world. The process is somewhat like the situation of a bacterium making observations about the surrounding tissue. Meier remarks on the fantastic output of monographs and books on organization theory in general and says that it is worth while at this time to undertake some kind of elimination contest. He says that he intends to select those studies concerned with principles that can be used for further exploration with simulation, that can be developed, and that show implications of action not really taken at the time that the case was observed. He considers several recent books in the field and finds especially noteworthy a 1959 collection of studies entitled *Comparative Studies in Administration* by J. D. Thompson and others (University of Pittsburgh), a monograph in 1960 entitled *Organizational Systems and Engineering Groups* by L. B. Barnes (Harvard Graduate School of Business Administration), and a good, if slightly outdated, review of the literature entitled *Leadership, Psychology, and Organizational Behavior* by B. M. Bass (Harper, 1960). His general comment is this:

"The 'organization' in all these studies, however, remains simply at the level of relationships between the leaders and the led, and those discovered among the led in the various situations that they may find themselves. The upper reaches of hierarchy are never probed." (p. 237)

As far as the establishing of a system is concerned, he gives his highest praise to an article by John L. Kennedy called "A 'Transition-Model' Laboratory for Research on Cultural Change" in *Human Organization Research* edited by R. N. Adams and J. J. Preiss (Dorsey Press, 1960). He mentions also the book *Management Organization and the Computer* edited by G. P. Schultz and T. L. Whisler (Free Press, 1960), which makes the startling prediction that within two decades computers should have enough capacity to take over the duties of most middle-level and higher executives, although the costs would be fairly high and would be undertaken only in those instances where executives could not be obtained more cheaply. There is some evidence, however, of a stubborn resistance in the rest of the organization toward electronic executives. He seems to think highly of the article "Simulation of Individual and Group Behavior" by G. P. E. Clarkson and H. A. Simon in *American Economic Review*, December, 1960, pp. 920-32. He calls the review on management games by K. J. Cohen and E. Rhenman, "The Role of Management Games in Education and Research" in *Management Science*, January, 1961, pp. 131-66, a landmark, and concludes his article by advocating simulation exercises for secondary schools. As he says,

"Little else in a high school curriculum is likely to be as challenging as a good quality game resembling closely some feature of the real world. Thus a battery of simulations is required whose characteristics are distributed according to two known dimensions—empirical detail and degree of abstraction achievable." (p. 246)

Meier also makes some suggestions for such simulation—what he calls subcomputer-size simulation: on the structure of language and the theory of the firm, on the synthesis of organized networks, on the reproduction of history (that is, significant eras of history could be replayed), on such public service operations as school administration, libraries, and community administrations, and even studies in ecology. As a result, he says first that it would be valuable for the recruitment of talent and as a basis for occupational counseling, and second, that experience by college and high

school students with different kinds of institutional prototypes should enable them to form and adjust to such organizational structures better, and in general would increase the adaptive capacity of our social system. Our system would be able to meet a wider range of exigencies and react with somewhat less confusion and delay than at present.

One criticism of the field in general, that is, in the repertoire of simulations involving human participations that have been developed to date, is that he finds too few formulations that dramatize and encapsulate situations where the players are expected to discover the public interest and act in ways that will maximize it. This reminds us of a comment by Norbert Wiener in the second edition of his book *Cybernetics* in which he compares computers to such workers of magic as appear in the "Sorcerer's Apprentice" and the fable of "The Monkey's Paw" by W. W. Jacobs:

"In all these stories the point is that the agencies of magic are literal-minded; and that if we ask for a boon from them we must ask for what we really want and not for what we think we want. . . . The new and real agencies of the learning machine are also literal-minded. If we program a machine for winning a war, we must think well what we mean by winning. "We cannot expect the machine to follow us in those prejudices and emotional compromises by which we enable ourselves to call destruction by the name of victory. If we ask for victory and do not know what we mean by it, we shall find the ghost (like the ghost of the lost son in the monkey's tale) knocking at our door."

This quotation is cited on page 27 of the December, 1961 issue of *The American Behavioral Scientist,* in that magazine's extremely useful section called "New Studies in Behavioral Science and Public Policy," an excellent annotated selection of items from 250 journals and reviews and from announcements and review copies of books recently published. Items of special interest are boxed. One of the boxed items in the December issue is the new book by René Dubos, *The Dreams of Reason.*

Dubos' book *The Dreams of Reason: Science and Utopias* (Columbia) exemplifies the remark of Ernest Renan that "everything becomes great literature when done with talent." Based upon a series of lectures given at Brookhaven in honor of the physicist George B. Pegram, this book by the eminent microbiologist is both a wise and warm one, and curiously

## FOR THE BUSINESS SPECIALIST

*K. J. Arrow, S. Karlin,* and *H. Scarf (eds.),* STUDIES IN APPLIED PROBABILITY AND MANAGEMENT SCIENCE (Stanford)

*Frank Baker (ed.),* VISUAL COMMUNICATIONS: INTERNATIONAL (Hastings House)

*Bela A. Balassa,* THEORY OF ECONOMIC INTEGRATION (Irwin)

*Jack Barbash,* LABOR'S GRASS ROOTS (Harper)

*E. L. Baum, H. G. Diesslin, and E. O. Heady (eds.),* SYMPOSIUM ON CAPITAL AND CREDIT NEEDS IN A CHANGING AGRICULTURE (Iowa St. Univ.)

*N. M. Bedford and others,* ADVANCED ACCOUNTING: AN ORGANIZATIONAL APPROACH (Wiley)

*A. J. Bergfeld and others,* PRICING FOR PROFIT AND GROWTH (Prentice)

*Abram Bergson,* THE REAL NATIONAL INCOME OF SOVIET RUSSIA SINCE 1928 (RAND study; Harvard)

*George F. Break,* THE ECONOMIC IMPACT OF FEDERAL LOAN INSURANCE: A SPECIAL PROJECT REPORT (Nat'l Planning Ass'n)

*William Brown and Charles Gilbert,* PLANNING MUNICIPAL INVESTMENT (Univ. of Pa.)

*R. C. Browne,* HEALTH IN INDUSTRY (Williams & Wilkins)

*Richard H. Buskirk,* MARKETING CASES AND READINGS (Holt)

CARBONI: TWENTY-FIVE PUBLICITY CAMPAIGNS (N. Y. Graphic Soc.)

*A. Charnes and William W. Cooper,* MANAGEMENT MODELS AND INDUSTRIAL APPLICATIONS OF LINEAR PROGRAMMING (Wiley)

*Earl F. Cheit,* INJURY AND RECOVERY IN THE COURSE OF EMPLOYMENT (Wiley)

*Louis Cheskin,* BASIS FOR MARKETING DECISION (Liveright)

*Henry M. Christman,* WALTER P. REUTHER: SELECTED PAPERS (Macmillan)

*G. H. Cole, L. Stein, and N. Sobol (eds.),* LABOR'S STORY, AS REPORTED BY THE AMERICAN LABOR PRESS (Community Pubs.)

*Daniel Creamer,* CAPITAL EXPANSION AND CAPACITY IN POSTWAR MANUFACTURING (Nat'l Ind. Conf. B'd)

*George B. Cressey,* SOVIET POTENTIALS (Syracuse Univ.)

*Alexander Eckstein,* NATIONAL INCOME OF COMMUNIST CHINA (Free Pr.)

*Hywell Evans,* GOVERNMENT REGULATION OF INDUSTRIAL RELATIONS: A COMPARATIVE STUDY OF UNITED STATES AND BRITISH EXPERIENCE (Sch. of Ind. & Labor Rel., Cornell)

*David E. Faville,* SELECTED CASES IN MARKETING MANAGEMENT (Prentice)

*Gerald C. Fischer,* BANK HOLDING COMPANIES (Columbia)

*Sanford Fox,* THE ERA OF CONTINUOUS PROSPERITY: ECONOMIC CONTROL IN FREE ENTERPRISE SOCIETY (Frederick Pr.)

*Joseph F. Gelband,* TAXATION OF SECURITIES TRANSACTIONS (Prentice)

*D. P. Gould,* MARKETING FOR PROFIT (Reinhold)

*Melvin L. Greenhut,* FULL EMPLOYMENT, INFLATION AND COMMON STOCK (Pub. Affairs Pr.)

*Elgin Groseclose,* MONEY AND MAN: A SURVEY OF MONETARY EXPERIENCE (Ungar)

*Stephen Habbe,* FOLLOWING UP ATTITUDE SURVEY FINDINGS (Nat'l Ind. Conf. B'd)

*J. A. Hamilton and others,* PATTERN OF HOSPITAL OWNERSHIP AND CONTROL (Univ. of Minn.)

*Werner Hochwald,* DESIGN OF REGIONAL ACCOUNTS (Johns Hopkins)

*Jordan A. Hodgkins,* SOVIET POWER: ENERGY RESOURCES, PRODUCTION AND POTENTIALS (Prentice)

*Francis E. Hummel,* MARKET AND SALES POTENTIALS (Ronald)

*Henry Jarrett,* COMPARISONS IN RESOURCE MANAGEMENT (Johns Hopkins)

*Naum Jasny,* ESSAYS ON THE SOVIET ECONOMY (Praeger)

*Dallas L. Jones,* ARBITRATION AND INDUSTRIAL DISCIPLINE (Univ. of Mich.)

*Kay and Palmer,* CHALLENGE OF SUPERVISION (McGraw)

*Saul B. Klaman,* THE POSTWAR RESIDENTIAL MORTGAGE MARKET (Princeton)

*Sherman Krupp,* PATTERN IN ORGANIZATION ANALYSIS (Chilton)

*James W. Kuhn,* BARGAINING IN GRIEVANCE SETTLEMENT (Columbia)

*Simon Kuznets,* CAPITAL IN THE AMERICAN ECONOMY: ITS FORMATION AND FINANCING (Princeton)

*William McGehee and Paul Thayer,* TRAINING IN BUSINESS AND INDUSTRY (Wiley)

*James E. McNulty,* DECISION AND INFLUENCE PROCESSES IN PRIVATE PENSION PLANS (Irwin)

*George C. Magnan,* VISUAL ART FOR INDUSTRY (Reinhold)

*Milton M. Mandell,* THE EMPLOYMENT INTERVIEW (A.M.A.)

*R. S. Mendelkorn (ed.),* VALUE ENGINEERING (E.I.A. Conf. on Value Engineering; Reinhold)

*John E. Moes,* LOCAL SUBSIDIES FOR INDUSTRY (Univ. of N.C.)

*Francis Murray,* MATHEMATICAL MACHINES (Columbia)

NEW 1961 MINIMUM WAGE LAW WITH EXPLANATION (Commerce Clearing House)

*J. H. Oldham,* WORK IN MODERN SOCIETY (John Knox)

*Guy H. Orcutt,* MICROANALYSIS OF SOCIOECONOMIC SYSTEMS (Harper)

*Mark Perlman,* THE MACHINISTS: A NEW STUDY IN TRADE UNIONISM (Harvard)

*Claude Robinson,* UNDERSTANDING PROFITS (Van Nostrand)

*Keith Rogers,* DETECTIONS AND PREVENTION OF BUSINESS LOSSES (Arco)

*Allan Rood,* JOB STRATEGY: PREPARING FOR EFFECTIVE PLACEMENT IN BUSINESS AND INDUSTRY (McGraw)

*Kurt Samuelson,* RELIGION AND ECONOMIC ACTION (Basic)

*Charles H. Sandage,* THE PROMISE OF ADVERTISING (Irwin)

*G. L. S. Shackle,* DECISION, ORDER AND TIME IN HUMAN AFFAIRS (Cambridge)

*Nathan Shefferman,* SHEFFERMAN PERSONNEL MOTIVATION PROGRAM (Prentice)

*W. P. Shepard, M.D.,* THE PHYSICIAN IN INDUSTRY (McGraw)

*Sumner Slichter,* ECONOMIC GROWTH IN THE UNITED STATES (La. St. Univ.)

*M. H. Spencer and others,* BUSINESS AND ECONOMIC FORECASTING (Irwin)

*Gavin Spofford,* GUIDEPOSTS FOR BANKING EXPANSION (Rutgers)

*Morris Stone,* LABOR-MANAGEMENT CONTRACTS AT WORK (Harper)

*Mortimer Taube,* COMPUTERS AND COMMON SENSE: THE MYTH OF THINKING MACHINES (Columbia)

*Stanley Vance,* INDUSTRIAL STRUCTURE AND POLICY (Prentice)

*E. L. Wallace,* MANAGEMENT INFLUENCE ON THE DESIGN OF DATA PROCESSING SYSTEMS (Harvard)

*Richard E. Walton,* THE IMPACT OF THE PROFESSIONAL ENGINEERING UNION (Harvard)

*Paul Wasserman,* SOURCES FOR HOSPITAL ADMINISTRATORS (Cornell)

heartening despite its debunking of the popular utopias expected of science. He takes great pains, however, to point out that although he demurs from an unlimited confidence in the power of science, neither can he subscribe to the idea of the bankruptcy of science. The general object of the Pegram lectures is to pursue the social and humanistic implications of science –to investigate just how science can contribute to the enlightenment and service of mankind.

The title and theme of the book come from a sentence of Goya's, "The dreams of reason can produce monsters." In consideration of the 400th anniversary of Francis Bacon's birth, Dubos commences his essay with the description of Bacon's unique position in the scientific revolution—unique, Dubos says, because his influence was exerted through words rather than deeds. "He did not add to knowledge, but became the prophet of scientific civilization." (p. 19) This was due principally to Bacon's insistence that scientific scholarship was useful only insofar as it contributed to factual knowledge and to the improvement of the human condition. As he quotes Bacon, " 'Knowledge, that tendeth but to satisfaction is but as a courtesan, which is for pleasure, and not for fruit or generation.' " (p. 22) As he concludes, "Bacon's significance in history is thus to have blown the clarion call which awakened Europeans to the fact that science could completely transform society." (p. 30) And in Dubos' view it was Bacon who "certainly contributed to the modern world its most characteristic aspect and its most lasting illusion when he created his utopia of happiness based on application of scientific knowledge." (p. 39)

In this fostering of the view that nature must be studied not so much to be understood as to be mastered and exploited by man, Dubos points out that the main issue now for scientists and for society as a whole is to decide what to do among all the things that could and should be done. Dubos is probably at his most devastating in his chapter on medical utopias, for it is his firm belief that although we can control many of the diseases that our ancestors took for granted, this does not prove that we can control disease problems of the future, or even, for that matter, of the present. Dubos says that each type of society has diseases peculiar to itself—that indeed, "each civilization creates its own diseases. Furthermore, there is no evidence that the techniques developed for dealing with the disease problems of one generation can cope with the problems of another. . . . Nature always strikes back. It takes all the running we can do to remain in the same place." (pp. 71 and 72) As he reiterates,

"To state it bluntly once more, my personal view is that the burden of disease is not likely to decrease in the future, whatever the progress of medical research or whatever the skill of social organizations in applying new discoveries. While methods of control can and will be found for almost any given pathological state, we can take it for granted that disease will change its manifestations according to social circumstances. Threats to health are inescapable accompaniments of life." (p. 84)

To Dubos, health is not so much a matter of drugs as of discipline. Furthermore, he sees only danger in an excessive striving for security and comfort—a danger, that is, to the survival qualities of the race. What we should concentrate on, he says, is developing our adaptive powers.

"The reason that we know so little about how to make people develop their own adaptive powers is that modern civilization has not concerned itself with this problem. Everywhere in the world, and in the United States in particular, the trend has been toward controlling and modifying the external enviroment for the sake of human comfort, with total elimination of effort as an ideal. We do little, if anything, to train the body and soul to resist strains and stresses. But we devote an enormous amount of skill and foresight to conditioning our houses against heat and cold, avoiding contacts with germs, making food available at all hours of the day, multiplying labor-saving devices, minimizing the effort of learning, and dulling even the slightest pain with drugs. Needless to say, I am not advocating a retreat from these practices which have made life so much easier although not necessarily very much happier. But I would urge that we emphasize more than we do now another approach to dealing with the external world—namely, the cultivation of the resources in human nature which makes man potentially adaptable to a wide range of living conditions." (pp 91-92)

In discussing the "illusions of understanding," Dubos casts some doubts on the efficacy of depending on analytical breakdowns into simpler and simpler components, instead of a more synthetic approach. In discussing such studies

### INTERNATIONAL BUSINESS

*Thomas Aitken*, A FOREIGN POLICY FOR AMERICAN BUSINESS (Harper)

*Hugh G. J. Aitkin*, AMERICAN CAPITAL AND CANADIAN RESOURCES (Harvard)

*J. Bes*, CHARTERING PRACTICE (Heinman)

*Tomas Fillol*, SOCIAL FACTORS IN ECONOMIC DEVELOPMENT: THE ARGENTINE CASE (M.I.T.)

*Klaus Franck*, EXHIBITIONS: A SURVEY OF INTERNATIONAL DESIGNS (Praeger)

*W. G. Friedmann and G. Kalmanoff (eds.)*, JOINT INTERNATIONAL BUSINESS VENTURES (Columbia)

*Theodore Geiger*, THE GENERAL ELECTRIC COMPANY IN BRAZIL (Nat'l Planning Ass'n)

*Ralph Hancock*, GUIDE TO PUERTO RICO (Van Nostrand)

THE INTERNATIONAL POSITION OF THE DOLLAR (Com. for Econ. Devel.)

*G. Reimann and E. F. Wigglesworth*, INTERNATIONAL GUIDE TO FOREIGN COMMERCIAL FINANCING (Internat'l Reports Inc.)

*Mary E. Schrieber*, EDUCATION FOR SOCIAL CHANGE: ESTABLISHING INSTITUTES OF PUBLIC AND BUSINESS ADMINISTRATION ABROAD (Wash. Univ.)

*Egon Sohmen*, FLEXIBLE EXCHANGE RATES: THEORY AND CONTROVERSY (Univ. of Chicago)

SOLVING FOREIGN BUSINESS PROBLEMS: CASE STUDIES OF 100 COMPANIES (Business Internat'l, N. Y.)

THE UNITED STATES BALANCE OF PAYMENTS POSITION (Report of Com. on Econ. Pol., 1961; U. S. Chamber of Com.)

*Billian White*, NATIONALIZATION OF FOREIGN PROPERTY (Praeger)

### INTERNATIONAL AFFAIRS

*John F. Amory*, AROUND THE EDGE OF WAR: A NEW APPROACH TO AMERICAN FOREIGN POLICY (Potter)

*Benjamin V. Cohen*, THE UNITED NATIONS: CONSTITUTIONAL DEVELOPMENTS, GROWTH AND POSSIBILITIES (Harvard)

*Erich Fromm*, IS WORLD PEACE STILL POSSIBLE? (Doubleday)

*Norton Ginsburg*, ATLAS OF ECONOMIC DEVELOPMENT (Univ. of Chicago)

*Leopold Labedz and Walter Laqueur*, THE FUTURE OF COMMUNIST SOCIETY (Praeger)

*Joseph P. Lash*, DAG HAMMARSKJOLD: CUSTODIAN OF THE BRUSHFIRE PEACE (Doubleday)

*Ernest R. May*, IMPERIAL DEMOCRACY: THE EMERGENCE OF AMERICA AS A GREAT POWER (Harcourt)

*Katharine and A. F. K. Organski*, POPULATION AND WORLD POWER (Knopf)

*John Phillips*, DEVELOPMENT OF AGRICULTURE AND FORESTRY IN THE TROPICS: PATTERNS, PROBLEMS AND PROMISE (Praeger)

*Washington Platt*, NATIONAL CHARACTER IN ACTION: INTELLIGENCE FACTORS IN FOREIGN RELATIONS (Rutgers)

*John Slessor*, WHAT PRICE COEXISTENCE? A POLICY FOR THE WESTERN ALLIANCE (Praeger)

*Jerome H. Spingarn*, NEW APPROACHES TO DISARMAMENT (For. Policy Ass'n)

*W. Montgomery Watt*, ISLAM AND THE INTEGRATION OF SOCIETY (Northwestern)

*F. O. Wilcox and Field Haviland*, UNITED STATES AND THE UNITED NATIONS (Johns Hopkins)

*A. A. Williamson*, BIOLOGICAL FORCES IN WORLD AFFAIRS (Pub. Affairs Pr.)

in the biological sciences, for example, he says,

"As a contrast to the unphilosophical endless accretion of 'scientific' facts concerning living matter, it is stimulating to rediscover in Aristotle's writings the entrancing throb of life.

"For those who believe that scientific biology is synonymous with the more and more refined study of well-defined, isolated reactions, it is chastening to remember that the greatest biological generalizations were not reached by this analytical method." (p. 116)

He was referring here to the Darwinian concept of evolution, which he saw as an inspired guess based on a sort of *Gestalt* awareness of complex relationships in natural situations. Like many biologists he was led to this view especially because, he says,

"Life is more than a self-replication of nucleic acid and protein molecules, supplemented now and then by a few mutational changes. It is more than the utilization of chemical energy for the synthesis and turnover of organic materials. Life is a creative process elaborating and maintaining order out of the randomness of matter, endlessly generating new and unexpected structures and properties by building up associations which qualitatively transcend their constituent parts." (pp. 119-20)

He repeats that a return to the Aristotelian philosophy will enlarge the scope of the biological sciences: the living organism cannot be understood except as an organized pattern of responses to the environment. And he repeats also that progress in science is not made by inductive analytical

knowledge, but by imaginative speculations of the mind, after which comes the analytic verification. He not only advocates a return to Aristotle but to a realization that ancient myths and literary images are meaningful in that they symbolize problems crucial for mankind that remain unsolved. Analytical techniques notwithstanding, such are precisely the problems upon which most modern scientific investigation focuses. For example: Is the cosmos made of rays or particles? What is the nature of life in the universe, where lifelessness is the rule and life the puzzling exception? And is man different qualitatively from the rest of the living world or only a higher specimen in its evolution? In fact, Dubos sees the history of science as a continuing debate between what he calls the proponents of the continuum and the atomicists, the first starting with Heraclitus and the second with Democritus. And he concludes this remarkable chapter with the statement that because ordinary language is vague, evolving as it does in immediate connection with reality,

"the common language may be more adaptable to the expansion of knowledge than our precise scientific terms which correspond to limited and selected groups of phenomena rather than to reality as a whole. Furthermore, human thought evolved in direct associations with nature. Our thought patterns are based not so much on recently discovered evidence as on perceptions long experienced and on facts long known which may have influenced the formation of human intellect. Indeed, the astonishing ability of the human brain to guess certain workings of the universe suggests that, in a limited measure at least, the brain mirrors some of its very patterns. In this light, it becomes less surprising that ancient philosophers perceived the central core of many of the problems of modern science and that their formulation of these problems presents great similarities to our own. The search for viable truths and all the other worldly preoccupations of science are but part of the high tradition of religion and philosophy from whence most knowledge originally sprang." (pp. 127-28)

As for the scientist himself, Dubos feels that despite the influence of Bacon, he is really betraying a public trust in succumbing to the idea that all scientific discoveries must eventually prove of practical use. As he says, "Scientists, like other men, win esteem and contribute to happiness more effectively by the exercise of wisdom than by the practice of power." (p. 156) And he concludes that long before Bacon and his theory of science as a servant of society, the original function of the scientist was that of a high priest of pure knowledge, with ancient claims that must be honored. On the other hand, he finds that the learned ignoramus found among scientists is also a familiar type in the humanities, and that it is not only the scientist who needs to relate his undertaking to a humanistic activity—who needs to relate his field, that is, to historical development, to emphasize its bearing on the future, and to recognize its relevance to other human interests. He concludes that man cannot achieve mastery over nature by the mere exercise of reason. Determined as man is by his own assumptions, the facts revealed to him are limited by the range of his reason.

"The perceptions of the scientist are the contacts through which his creative power is kept alive and healthy. They provide the substantial food which generates a deeper kind of objectivity, more true fundamentally than factual evidence. Deprived of this human quality, reason tends to spin cobwebs, or to create nightmares that alienate science from man. . . . Science is like a revelation that enlarges awareness by sharpening and extending the direct perceptions from which philosophy originated." (pp. 166-67)

EACH OF the authors covered above tilts with stereotyped approaches to current problems.

In making this protest most explicit and articulate, Dubos' book reminds us of the Sphinx and her riddle in *Oedipus*. Perhaps the Greek audiences knew that when Oedipus answered the riddle (What walks on four feet in the morning, two feet at noon, and three feet in the evening? Answer: man) and raised the plague from Thebes, the riddle was only superficially answered —that, in fact, the real riddle was, "What is man?" And with the symbolic fall of Oedipus himself, the real extent of the "plague" was revealed. Dubos seems to be saying that until man really knows himself—body, mind, and environment—he has little hope of raising the plague and ushering in any utopia.[5]

[5] Dubos has an excellent article in the fiftieth anniversary issue of *The Yale Review* (August, 1961), which we will discuss in the context of the entire anniversary issue—an unusually fine collection of articles, together with the *Daedalus* issue (Fall, 1961) on "Excellence and Leadership in a Democracy," in the next "Book Notes."

# ADVERTISING INDEX



**Sp—Spring, 1961; S—Summer, 1961**
**F—Fall, 1961; W—Winter, 1961**

## BOOKS RECEIVED

Andrews, Stanley. *The Farmer's Dilemma,* Public Affairs Press, Washington, 1961. $4.50.

Cochran, Thomas C., and Miller, William. *The Age of Enterprise.* Harper Torchbooks, The Academy Library, Harper & Brothers, New York, 1942, revised 1961. $2.35.

Cooke, Helen J. *The Role of Debt in the Economy.* Public Affairs Press, Washington, 1961. $3.25.

Cooper, Joseph D. *The Art of Decision Making.* Doubleday & Company, Inc., Garden City, N.Y., 1961. $4.95.

Edwards, James Don, and Salmonson, Roland F. *Contributions of Four Accounting Pioneers.* Bureau of Business and Economic Research, Graduate School of Business Administration, Michigan State University, East Lansing, 1961. $6.50.

Hoos, Ida Russakoff. *Automation in the Office.* Public Affairs Press, Washington, 1961. $4.50.

Houston, George C. *Manager Development: Principles and Perspectives.* Richard D. Irwin, Inc., Homewood, Ill., 1961. $9.35.

Lansing, John B.; Ginsburg, Gerald P.; and Braaten, Kaisa. *An Investigation of Response Error.* Bureau of Economic and Business Research, University of Illinois, 1961.

Letwin, William, ed. *A Documentary History of American Economic Policy Since 1789.* Doubleday & Company, Inc., Garden City, N.Y., 1961. $1.45 (paperback).

Luck, David J.; Wales, Hugh G.; and Taylor, Donald A. *Marketing Research.* (2d ed.) Prentice-Hall, Inc., Englewood Cliffs, N.J., 1961. $11.35.

Kibbee, Joel M.; Craft, Clifford J.; and Nanus Burt. *Management Games.* Reinhold Publishing Corp., New York, 1961. $10.00.

Milward, G.E. *Launching and Managing O & M* (Organization & Methods). St. Martin's Press, Inc. 175 Fifth Ave., New York, 1961. $3.50.

Rogers, Anna C. *Graphic Charts Handbook.* Public Affairs Press, Washington, 1961. $6.00.

O'Neal, F. Hodge, and Derwin, Jordan. *Expulsion or Oppression of Business Associates: "Squeeze Outs" in Small Enterprises.* Duke University Press, Durham, N.C., 1961. $10.00.

Ryan, Robert H. *Corpus Christi: Area Resources for Industry.* Bureau of Business Research, College of Business Administration, The University of Texas, 1961. $3.00.

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White, Frederick. *American Industrial Research Laboratories.* Public Affairs Press, Washington, 1961. $6.00.

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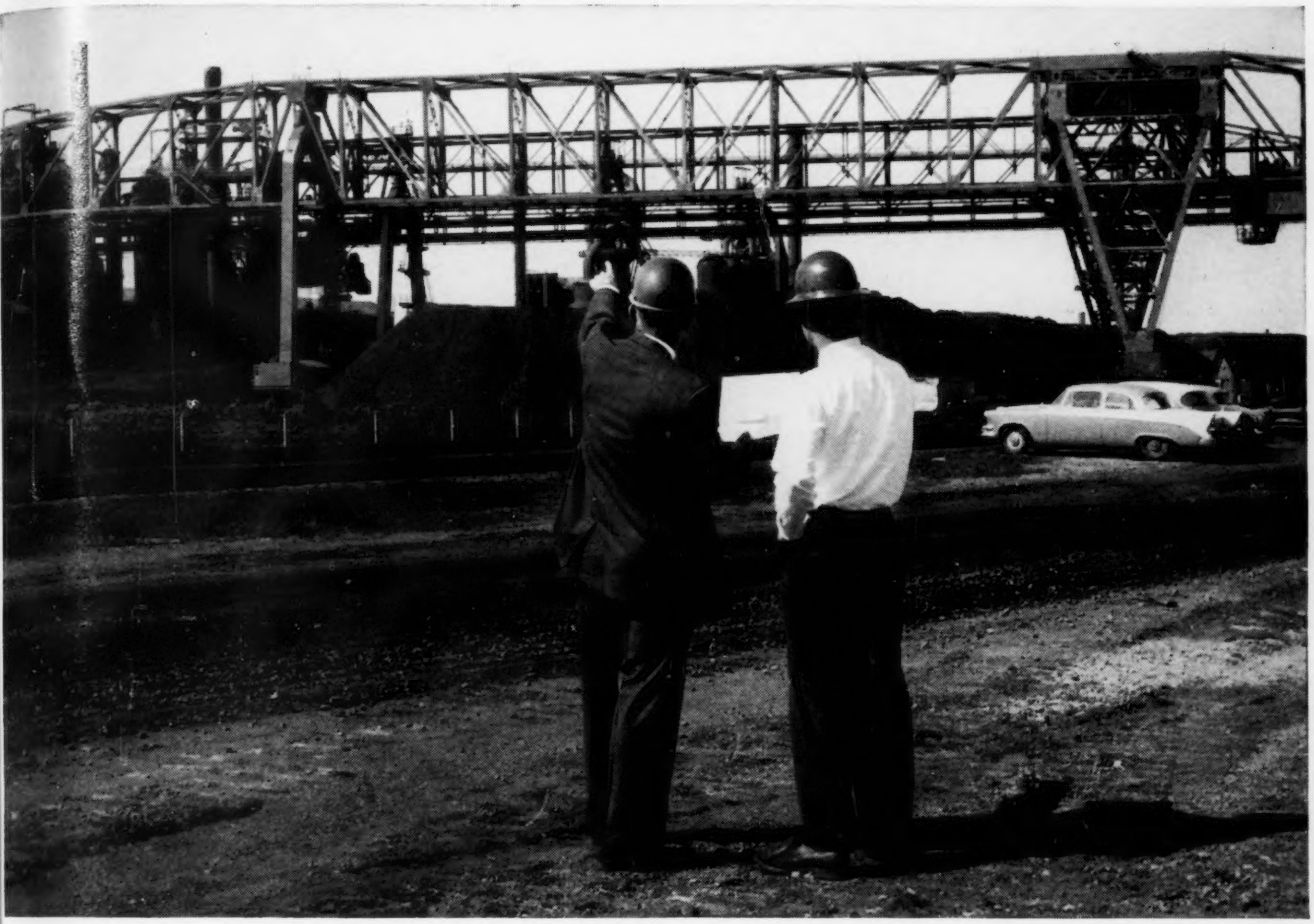
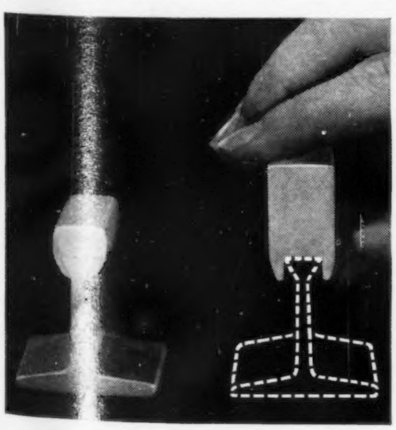


# Another way copper from Anaconda is helping cut the cost of getting electricity to the job

It's not a simple job to get electricity to big heavy-current motors that travel on moving cranes, ore bridges, monorails. In heavy-duty use where high amperage is needed, steel rails weighing 60 to 80 pounds per yard have carried the power. Then came extruded aluminum rails that were lighter and easier to install. But aluminum would wear and pit from friction of the current collectors unless protected by grease. Furthermore, unprotected aluminum rails if not used for a while acquire an oxide coating that is an electrical insulator.



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## ARTICLES



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# BUSINESS HORIZONS

SPECIAL ISSUE ✸ *FIRST INTERNATIONAL SEMINAR ON MARKETING MANAGEMENT*

SCHOOL OF BUSINESS

INDIANA UNIVERSITY

*IT IS with pleasure that we publish this special supplement to Business Horizons. We hope that it will be the first of many special bonus issues dealing with activities and topics of particular interest to our subscribers. These issues are, of course, complimentary to our regular subscribers.*

*This first special issue presents a report of the* FIRST INTERNATIONAL SEMINAR ON MARKETING MANAGEMENT, *which took place on the Indiana University campus in February. The purpose and background of this conference are discussed on pages 6 and 7.*

*It is difficult to capture in print the value and the content of a conference of this kind. Much of the benefit of such a meeting comes from personal association and discussion with the top executives who attended. Yet we feel that the content of the conference sessions deserves a wider audience, and this special issue is an attempt to share the events and the content of the seminar with our readers.*

*Finally, a word about the format of this issue. It should not be regarded as merely a report of proceedings. Each subject area has been presented in the form best suited to the material. Although some of the authors have written formal articles, most have chosen to present informal summaries of their topics. We hope that you will find this information both interesting and useful.*

# *FIRST INTERNATIONAL* SEMINAR ON MARKETING MANAGEMENT

*february* $\frac{5}{18}$ 1961

*the*
DEPARTMENT OF MARKETING
**INDIANA UNIVERSITY SCHOOL OF BUSINESS**

&

*the*

**EUROPEAN PRODUCTIVITY AGENCY**

**BLOOMINGTON, INDIANA**

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## ABOUT THE SEMINAR

THE DEVELOPMENTS that are occurring today in the study and practice of marketing are both promising and exciting. In the United States, much new literature is being produced that deals with the marketing management concept and with new tools for analyzing marketing problems. Interesting applications are being developed from both the behavioral sciences and the formal studies of quantitative analysis. At the same time, we are experiencing dynamic organizational changes brought about by such movements as decentralization and an upgrading of the marketing function in the firm; these developments are especially conspicuous in American industry. In Europe, also, dynamic changes are occurring in both institutions and practices. The dramatic development of the supermarket, the growth of formal marketing research, and added emphasis to the study of marketing are only a few of these changes. All this is happening in the new setting of the common market and the free trade area.

With this ferment in marketing, not only in the United States and Europe but in other parts of the world, it is understandable that attention should turn to the exchange of information concerning marketing practice, research methods, and research findings. Teams of businessmen have traveled from the United States to discuss marketing with their counterparts in many European countries and to study practices abroad. Likewise, several European executives have visited companies in the United States with similar intentions. The European Productivity Agency has helped arrange for consultations and study groups; although these have dealt with many concepts of business, a great deal of attention has been given to marketing.

Obviously, there existed a need for an international seminar on marketing management, a forum in which leading marketing executives from many parts of the world could join in seminars to share their knowledge and experience and to formulate ideas for new ways of marketing goods and services. The first such seminar was held on the campus of Indiana University in February, 1961 under the cosponsorship of the School of Business at Indiana University and the European Productivity Agency. Participants included twenty major executives from twelve countries in Europe and fourteen top marketing executives from various industries in the United States. This group was joined by members of the marketing faculty, who served as seminar coordinators, and several other members of the School of Business. In addition, nine professors and nineteen businessmen joined the group for brief periods and, as either a seminar leader or a consulting faculty member, contributed to the discussion of specifically assigned topics.

The seminar centered upon a study of marketing management, not foreign trade. The first session was devoted to problems of organizing for marketing, and was followed by a study of markets, with attention to both behavioral aspects and problems of measurement and forecasting. One session was reserved for examining problems of coordinating production in marketing. The second week of the seminar concentrated on marketing strategy with careful consideration of an exchange of the latest and most advanced thinking on product development and adaptation, pricing, promotion, and channels and institutions. Special attention was given to indus-

trial marketing and to selected problems of importing and exporting.

The composition of the seminar group naturally contributed to the breadth and international flavor of much of the discussion. Traditionally, students of marketing in the United States have been inclined to study American practices and to ignore what is going on in other parts of the world. The discussions in the seminar clearly revealed many advanced ideas and practices in other countries; indeed, in some phases of these activities, Americans appear to be followers rather than leaders. For example, Europeans have long been forced to follow marketing practices based upon a concept of marketing segmentation because the numerous European countries, in and of themselves, form market segments for their products. Many of these practices are adaptable to the American scene. Conversely, with the advent of the common market and the free trade area, the many practices suited to mass markets in the United States are becoming increasingly relevant and applicable in Europe.

In addition to the regular seminar sessions, the participants met on several occasions for informal discussions, referred to as "fireside chats," with a number of leading American businessmen. On the opening evening, John Barr, Chairman of the Board, Montgomery Ward & Company, discussed "The Changing Nature of Retailing." A second informal evening discussion was led by Basil Walters, Editor of the Chicago *Daily News*. Others included W. W. Tongue, Economist, Jewel Tea Company, who discussed, "Trends in Self-Service Retailing"; Al N. Seares, who spoke on "Developing Marketing Manpower"; and John K. Langum, who analyzed the balance of payments problem. In addition, His Excellency Fernando Berckemeyer, Ambassador of Peru, joined the seminar for a luncheon and spoke to the group at that time. The Honorable Matthew E. Welsh, Governor of the State of Indiana, also attended one of the closing sessions and discussed problems of mutual interest.

For the European participants, the seminar program included a carefully planned schedule of visits to a number of American firms. The entire group held conferences and discussions with some of the executives and leading officers at the Chicago Board of Trade, the Inland Steel Company, the A. C. Nielsen Company, the Ford Motor Company, the Watchmakers of Switzerland, Time-Life International, General Foods Corporation, Stewart Dougall Associates, and McGraw-Hill Publishing Company, Inc. In each case, there was a mutual exchange of information on common problems and marketing practices. In addition, each of the European participants followed a private itinerary for several days and was enabled to exchange views with company executives in industries similar to his own, or in companies with somewhat common problems of product and general distribution methods.

At the close of the seminar, the participants organized an International Marketing Council. Procedures were established for exchange of information on a regular and permanent basis and for future meetings. Thus, the seminar served as a starting point for a long-range program of study for members of the group.

SCHUYLER F. OTTESON
*Chairman, Marketing Department*
*Indiana University*

## OPENING ADDRESS

PRESIDENT WELLS, Members of the Faculty, Ladies and Gentlemen:

There have been many occasions when I have had the opportunity to be here at Indiana University to talk on European economic affairs, but none has been quite so special as today.

I feel, in fact, that the seminar we are inaugurating is an occasion for special rejoicing in that it represents a landmark: a point of arrival and a point of departure. And this not only for the organization which I have the honor to represent, but for the countries, the nationals of which are gathered here today. This event is a point of arrival because it is an undeniable fact that, after a decade of economic cooperation, Europe is today fully recovered, indeed economically stronger than it has ever been before. The realization of this fact, and the realization that economic recovery carries with it responsibilities as well as advantages, is the point of departure for the work which lies ahead of us in the sixties.

The Organisation for European Economic Co-operation has been the central coordinating body to which much credit is due for European recovery. Its task is now accomplished and we are undergoing a reorganization, which will culminate in a new Atlantic rather than European body, geared to the problems which face this free, democratic Western world to which we all belong.

The new Organisation for Economic Co-operation and Development, with full United States and Canadian membership, is now being born. It will no longer be a question of transferring American technological advances to Europe, but rather of creating a common pool of knowledge from which all the partners in this Western endeavor can benefit.

This seminar represents the first of such new activities. It brings together students of market economy from thirteen of the member countries, so that they may exchange their knowledge, consult on the present situation, and study what trends and possible action are foreseeable for the future. I consider it highly appropriate that the first of such joint Western seminars should be held at Indiana University. This institution has played such a great role in the past and has so generously helped Europe in the development of its new management during the decade of reconstruction that it seems fitting, not only by virtue of the past but of augury for the future, that it be chosen to inaugurate this new program.

It gives me great pleasure, therefore, to pay tribute to Indiana University and, at the same time, declare open the First International Seminar on Marketing Management.

OTTINO CARACCIOLO DI FORINO
*Head, Organisation for European Economic Co-operation, European Productivity Agency Mission*

SCHUYLER F. OTTESON, *Coordinator*
Chairman, Department of Marketing
Indiana University

WENDELL SMITH, *Seminar Leader*
Vice-President, Marketing Planning
Radio Corporation of America
Past President, American Marketing Association

*Consulting Faculty*
ARTHUR FELTON
Director of Marketing, American Brake Shoe Company

JOHN R. SARGENT
Partner
Cresap, McCormick & Paget

PAUL J. GORDON
Associate Professor of Management, Indiana University

FREMONT A. SHULL, JR.
Assistant Professor of Management, Indiana University

# ORGANIZING FOR MARKETING

## FACTORS THAT SHAPE THE ORGANIZATION

WENDELL SMITH

SINCE NO two enterprises have the same, or even very similar, marketing tasks to perform, it would be sheer coincidence if any one marketing organizational structure proved the most suitable for more than one business. This paper will discuss some of the marketing factors and circumstances that determine what is needed organizationally to establish total effective marketing and achieve volume and profit goals.

Marketing considerations are fundamental to virtually all decisions regarding business plans and policies. Investment and capital budgeting decisions revert to the kinds of facilities needed to supply the markets of the future. Personnel recruitment and training are preparation for the tasks that the customer needs of tomorrow will impose. Budgets for technical research and development will be devoted increasingly to product ideas that afford evidence of promising markets. This central role means that marketing plans and programs must include more of the quantitative and precise detail common in areas such as accounting.

The facts and insights provided by quantitative marketing research and sales analysis do not offer automated or even mechanized marketing management. They do serve, however, to limit the uncertainty with which executives must grapple. Decision-making time can then be concentrated upon resolving key issues; it is not dissipated over broad

This article has been adapted for seminar purposes from material appearing in Wendell Smith, "The Role of Marketing in Planning," *Business Horizons*, II (Fall, 1959), 53-57.

areas because of lack of information as to what the key issues and action alternatives really are.

One might well ask, "Why is it that scientific marketing came to the fore much later than scientific management in the area of production?" Many reasons could be given, but the most important is to be found in our shift from an economy of scarcity, during which production considerations were stressed, to an economy of relative abundance, which tends to bring market and sales considerations to the foreground and into proper perspective. It seems clear, then, that the rational approach to marketing management is one in which effective use is made of the following: (1) forecasts, and plans and programs designed to chart the future course of business; (2) check-points by means of which marketing operations can be controlled; (3) established criteria or yardsticks by means of which marketing results and man power can be evaluated at the appropriate times.

Marketing research and planning techniques and procedures can be applied to almost every phase of the business operation. They have been used successfully in connection with problems ranging from capital budgeting and financial planning on the one hand, to provision of a rational basis for the deployment and use of sales man power and determination of advertising requirements on the other. Much time could be devoted to detailed discussion of the diverse applications of the art; however, emphasis should be put on the three primary functions of planning, operational control, and evaluation of marketing and sales results. I should also like to suggest what an organization designed to provide a rational approach to these functions holds for the future of marketing and sales management.

An effective marketing organization is oriented toward planning for the future, controlling operations in the present, and evaluating what has transpired in the immediate past.



## THE ORGANIZATION

### *Planning*

Marketing planning, in its initial phases, draws heavily on industry and company records and other sources of internal data. If past procedures are continued, the latter sources of data can be analyzed to indicate marketing performance in the year ahead. These preliminary projections are then adjusted for expected changes in economic activity, in product line, product design, or other company actions that will affect marketing and sales.

Such adjusted forecasts are then ready for discussion and review. We may simply accept the marketing results indicated as our goals and request budgets for the time, money, and effort necessary for their achievement. More frequently, however, the reaction will be, "Surely we can do better than that," and a series of discussions will get underway on what can be done to sharpen the marketing effort in order to make a forecast of improved performance feasible. Fully developed marketing plans, then, which include realistic estimates of sales performance, furnish important guides for the planning of the production and financial aspects of the business.

Estimating the results of marketing new products creates special problems in planning. Frequently these problems can be partly solved through analysis of marketing information contained in government reports and trade association publications. In other instances, specially designed field projects must be initiated.

The end product of marketing planning, of course, is a detailed blueprint of the marketing actions to be taken during the period covered by the plan. Such a blueprint will include specifications of product line, plans and schedules for advertising and sales promotion, as well as strategies, plans, and programs for the use of the company's sales force. It is truly a flight plan designed to meet in advance the thunderstorms and

cross-winds that may be encountered along the way. Its objective is to minimize the crises and waste that are common where marketing is not planned and to save the panic button for real emergencies over which we have no control.

### *Operational Control*

The marketing plan will be incomplete if it fails to specify bench marks of expected performance against which actual performance can be checked at specified times. Just as the aircraft pilot periodically checks back with flight control, marketing personnel must check their progress against the plan or the "par" that has been established. Deviations from planned performance (quotas) may indicate that someone is falling down on the job or that predetermined plans are now unrealistic in terms of changed conditions. If the latter turns out to be the case, plans must be revised. One may very well ask, "What is the good of having plans if they are constantly being revised?" It is a fact that "meeting developments" by revising plans results in a more successful and rational adjustment to changed conditions than is true of the business that is not planned ahead and thus is constantly "flying by the seat of its pants."

### *Evaluation*

At the close of each month and in greater detail at the close of each quarter of the business year, it is desirable to compare the marketing results with the goals that were set in the marketing plan. This procedure allows consideration of basic points of emphasis in connection with future operations. Evaluation of this sort, of course, is done by almost all business organizations; but in those that do not have marketing plans and continuing analysis of marketing activity, the standards or criteria against which performance is evaluated are vague and based largely on judgment. Only if objectives have been clearly defined can it be determined whether or not those objectives have been achieved. This is true of the marketing program as a whole and also for its important elements such as advertising and personal selling.

## INTERACTION

There is little argument among sales and marketing managers as to the general desirability of engaging in planning, control, and evaluation of sales and marketing activities. However, it is not generally recognized that it is just as dangerous to plan, control, and evaluate by intuition as it is to dispense altogether with these functions. These three closely interrelated concepts imply the need for a rational approach if they are to be successful. A plan based upon hope alone is often worse than no plan at all, because others often take plans seriously as bases for budgeting and production planning.

The almost complete interdependence of successful planning, operational control, and evaluation is not generally understood. Plans are of little value unless they become the basis for controlling operations and evaluating results. Effective control of operations is impossible without the bench marks that can be provided by the plan, and control is weakened unless it is understood that it will be followed by evaluation of results in terms of both programs and the performance of people. Similarly, evaluation is futile, in fact impossible, unless control records over a period of time are available for evaluation against the performance objectives defined in the plan.

Once the sales or marketing manager becomes convinced that planning, control, and evaluation are tools that make it possible for him to utilize his creativity and imagination more fully, he benefits from the rational approach. First, and perhaps most important, rationality (in an area of the business often thought to carry an aura of mystery and hucksterism) goes a long way toward securing for marketing management a place at the conference table where over-all, company-level policies are being made. For many

years, we complained vociferously that top managements were production oriented in their thinking, and as a result the leadership that could be provided by people in marketing was going unused. Today, however, most successful top managements are market oriented. The doors of executive committee and board rooms are open to marketing and sales executives who can back up their judgments with facts and analysis, rather than resting their case upon an intuitive "feel of the market" or the opinion of the last distributor they happened to talk to.

### SETTING OBJECTIVES

Much has been said about the sequence of steps involved in the development of sound marketing plans. The first step is usually identified as the determination of goals or objectives to be accomplished by means of the marketing action that is being planned. This step presupposes, of course, that the firm or division has in its possession the results of a careful audit or review of its present position as a foundation upon which to determine realistic goals. If the firm is not fully aware of the "characteristics" of the launching pad from which it is planning to get into orbit, such planning analysis must precede the process of goal definition.

Those experienced in the planning of marketing activities tend to approach the finalizing of goals cautiously and often come to regard alternative sets of goals somewhat in the light of hypotheses to be tested, with the selection of the appropriate alternative as an important product of the planning operation. This is true because the feasibility of a goal can be evaluated best by careful consideration of the plan of action necessary for its achievement. It is at this exploratory, perhaps experimental, stage in the planning process that considerations of marketing strategy begin to play their part in the development of the final plan of action with timetables, budgets, campaigns, and schedules for the distribution of personnel. These products of the planners' art become the specifications within which advertising, sales promotion, and sales management use the marketing tools that they administer with skill and precision to produce the planned objective. The marketing plan embraces specifications for all selling activities as elements in the planned marketing mix.

### MARKETING STRATEGY

Marketing strategy, however one defines it, is primarily concerned with the creative elements of a goal-directed marketing plan. It describes the way the firm or division plans to get from where it is to where it wants to be. Marketing strategy, then, becomes the factor that integrates and coordinates the many and diverse tactics to be stipulated in the marketing plan itself. While marketing strategies are inherently creative, a genius is not needed to conceive and develop them. In fact, an orderly method of developing strategic concepts is one of the most basic aspects of total marketing. In general, marketing strategies evolve from studying the firm itself, the competition, and the market.

The generation of marketing strategies begins essentially with a careful review of present position in relation to competition and to the markets. Such analysis rather quickly reveals whether the strategy should be essentially defensive—that is, designed to compensate for and to correct weaknesses in the present operation—or offensive in the sense of leading to plans designed to capitalize upon the relative strengths or advantages of the firm. A defensive strategy might well be one designed to eliminate a weakness, thereby increasing the profitability of an existing volume of sales. An offensive strategy is often oriented toward increasing profits by pumping additional products into the market with disproportionately small increases in total marketing costs.

Many marketing strategies are developed with principal reference to the present and future behavior of competition. Again strategy may be essentially defensive insofar as

it may be influenced by present or expected competitive threats, or it may be offensively directed at points at which competition is or is expected to become vulnerable. Such elements are probably present in most strategic concepts whether stated or not. The most important and fundamental of marketing strategies, however, are those that are related directly to the accomplishment of goals that are defined in terms of the market itself. Solid knowledge of the market is the basis of such strategies.

Much time could be spent in elaboration of the almost unlimited list of market-based strategies that could be developed and adopted as guides to the planning of marketing activities. Obviously, strategies generated from market study must be feasible in view of the characteristics of the firm and the competition. Let us look at two examples of the ways in which market data may suggest an orderly method or approach to strategy generation.

First, analysis of trends in demand for present products or services is fundamental. An unfavorable trend in demand suggests a choice between a strategy designed to reverse the trend or one to accept and adjust to this development. A favorable trend suggests a choice of strategies concerned with how the firm can profit most from this happy state of affairs without overextending or producing imbalance.

Second, analysis of market structure will reveal whether the market is characterized by *homogeneity*, a situation where the requirements of consumers or users are very much the same, or *heterogeneity*, where the varied individual requirements cause dissatisfaction with a limited or proprietary offering. In the first case, one would logically follow a strategy designed to make individual market demands converge on a single product or limited product line. This is usually accomplished by differentiating the product from competition through heavy advertising and promotion, and presenting it as "all things to all people." On the other hand, if the structure of the market is characterized by heterogeneity, the decision may be to accept this divergent demand as a market characteristic and to adjust product lines and marketing strategy accordingly. This may result in a long line or a production-to-order situation. Whatever the choice, knowledge of market structure is essential to strategy determination.

To SUMMARIZE, it has been my purpose here to suggest, first, that the hard core of the total marketing concept that is attracting so much attention today is effective and scientific use of market planning; second, that the first, and perhaps crucial, phase of the planning process is the generation of marketing strategies or strategic concepts that guide the specifics of the planning operation and offer the essential links between the present market position and the predetermined goal. Last, this creative component of planning, marketing strategy, is developed by study of the firm, competition, and market.



Total marketing has five organizational implications:

1 The position of the marketing organization within the firm or the division must provide for effective coordination of the marketing planning with that being done in connection with all other functions, specifically, product, finance, facilities planning, and production scheduling.

2 Each division or firm must carefully evaluate the appropriateness of its organization to the achievement of effective planning, control, and evaluation of marketing operations. Further, we must be willing to accept the fact that it is more important for marketing organizations to be in tune with the tasks they have to perform and the markets they serve than to conform with some traditional, or popular pattern. To be sure, there are many general principles of marketing organization that must be respected, but tailor-made organizations, like tailor-made suits, fit best.

3 The all-important functions of planning, control of operations, and evaluation of re-

sults must be specifically assigned. From experience, we know that planning activities in particular will get shoved aside unless we can create a sense of urgency about planning for the future that is comparable to the urgency we feel for current operations.

4 The organizational structure must make specific provision for effective coordination and integration of both plans and operations concerning the product line, channels of distribution to be used, personal selling effort required, and the advertising and promotional support to be applied.

5 The organizational structure should be designed so as to accommodate, without revolutionary change, the addition or deletion of products, product lines, or whole businesses.

A company must have, particularly from a marketing point of view, maximum flexibility, adaptability, and sensitivity to new opportunities for growth and profit.



These are the specifications that marketing organizations must meet if they are to survive and operate profitably in the 1960's. Two crucial points may well mean the difference between success and failure: the firm must be able to adjust continuously to the dynamics of the markets that it serves, and it must also be able to gain lead time on crises in such a way that a rational plan for future action is a matter of urgency.

## THE MARKETING CONCEPT IN ACTION

ARTHUR FELTON

SINCE WORLD WAR II certain American business concepts have become fads, hailed as panaceas for all that is wrong with business and then replaced by newer ones. We have passed through linear programming, statistical quality control, operations research, long-range planning, into the throes of diversification, motivational research, and now the currently popular "marketing concept."

There is nothing wrong with being fashionable. But as the husband of any stylish woman can tell you, fashion can be very expensive—and it will not necessarily look well. A management concept that is fashionable may not suit *your* company, any more than every Dior creation will be flattering to *your* wife.

Many American businesses have rushed into diversification, mergers, or "total marketing" without really knowing what they were letting themselves in for. Properly applied, any of these concepts can do an amazing amount of good for the companies it fits. But none of them is a cure-all, and none of them is a substitute for sound basic management. If such concepts are instituted where they do not fit, they actually will do more harm than good.

This holds especially true for the marketing concept. It is fashionable now, and millions of words have been written during the last five years describing the wonders it can perform. But a company courts disaster if it adopts the marketing concept without creating the conditions that make it work or if it believes it will solve problems caused by poor management.

The marketing concept can be defined as a corporate state of mind that insists on the integration of all of the marketing functions. These, in turn, are to be coordinated with all other corporate functions for the basic objective of producing maximum long-range corporate profits.

The most important ingredient in a formula for marketing success then is the proper state of mind. Without this, a business, even though it is organized along the lines of a proven formula, will fail or at least operate far below proper efficiency. The board of directors, the chief executive, and the top-echelon executives must appreciate the need to develop this marketing state of mind. It is a lack of understanding of this need that is currently causing many corporations untold anguish in the execution of their marketing plan. Without this conditioning, all that

is accomplished organizationally in the textbook manner is of no avail.

Another important condition that must be met is an actual integration of all the marketing functions, such as sales, advertising, promotion, and marketing research. These functions, in turn, must be fully coordinated with production, personnel, finance, and all other functions in today's modern, complex corporation. Finally, professional and executive skills of a high order must be utilized. It is necessary to take all of this complex functioning and make it work, so as to produce the optimum long-range profit as set forth in a well-developed long-range plan.

## MARKETING FUNCTIONS

Inherent in the American marketing concept is the philosophy that the customer is king. Consequently, the thinking of all corporation personnel should be directed toward servicing our customers' needs as well as we can, but at a profit. This is also referred to as being "customer-oriented." To carry out this customer-oriented philosophy, it is important that our thinking revolve around the customer.

Customer-oriented marketing can be thought of as the performance of three functions, which in turn are composed of many other marketing functions. These basic functions can be called: (1) product development, which can be either the development of new products or the improvement or modification of present products; (2) the development of an integrated marketing plan; and (3) the distribution of the product to the customer. All of these must be carefully planned and related to each other in order to form a completely integrated and coordinated package.

### *New Product Development*

One way to illustrate coordinated product development is to describe the four-phase plan for new product development we are evolving at American Brake Shoe Company.

*Preliminary Screening.* — Generally, this will be an informal group evaluation as to whether a product idea is worth further consideration or whether it is patently impracticable. A new product idea or improvement can come from any source—a salesman, a product manager, technical laboratories, company personnel not connected with sales or research, or even an outsider. We try to do nothing that would discourage creative thinking and ideas. If a division head, the technical director, and the marketing director feel that the idea has merit, we go on to the second phase.

*Preparation of Feasibility Studies.*—This phase normally involves two considerations: technical research and marketing factors. The studies may be carried on simultaneously; in this case, while the appropriate technical research laboratory is studying the various approaches to developing a product from an idea and estimating the probable cost of such development, the marketing department can be making a quick check of the market factors involved.

The task of market research is to estimate what the market might be for such a product, and the present and future competitive climate. They are also asked to ferret out the facts or even rumors concerning possible competitive developments and give a quick evaluation of the selling problems that might be involved. This is an attempt to evaluate whether or not the proposed product is likely to require a marketing approach totally different from the present one. Though we do not necessarily limit our considerations of marketing and manufacturing processes to our present methods of doing business, however, we do feel it is important to be cognizant of the new elements that might arise and throw them into the evaluation hopper.

When these two studies are completed, we meet again to review the technical and marketing considerations and make our recommendations as to whether further work should be undertaken. The project could be dropped at this stage if the technical staff

estimates that development costs will be too expensive or manufacturing too impractical, or it may also be abandoned if the marketing department feels that there is insufficient profitable market or that the competitive conditions would create selling problems for our particular company. If conditions look favorable, we continue to phase three.

*The Research Project.*—In most cases, our marketing research project would be designed to measure the market for the new product more accurately, if in fact the market is measurable. Or, it may be asked to do its best to evaluate the sales potential of the new product for which there may not even be a current market. We would also be determining the geographical location of this market. We would be particularly careful to break it down by product categories, which might include size, shape, color, and performance. In the interest of research efficiency, we would at the same time study customer buying habits, channels of distribution, selling, advertising, and promotional requirements and evaluate in detail competitive activity in this field.



At this stage the marketing department might recommend either dropping the project or redirecting the development effort. We might, after more detailed investigation, decide that either the competitive conditions or market size is unfavorable. Alternatively, we might determine that a modification in the product design would qualify us for a more profitable market than the one originally selected.

Now you might ask, why not make a more detailed market survey in phase two, and thus save the research expenditures of the second market study. First, of course, we hope that we could detect any serious weaknesses our first time around and recommend stopping development work. On the other hand, this is not always possible because there are occasions where technical research is not sure what sort of an animal it is likely to produce until it has spent considerable time and money on actual research work. Also, in a company such as ours, with nearly a $3.5 million technical research budget in a headquarters research division working for nine autonomous operating divisions, there are so many ideas screened and considered feasible that to conduct dozens of $10-25,000 detailed marketing research studies might cost more than the preliminary research expenditures. In fact, we plan to make market studies for only the major projects. I might also add that a very high percentage of new ideas is killed in the first phase. In reality, we are constantly trying to balance our two expenditures by means of executive judgment.

Assuming we come up with favorable recommendations from this second marketing research study, and that technical research reports progress according to expectations, we enter the fourth phase.

*Design Completion.*—In most cases we have found that a very careful analysis of our second market research project has enabled us to pinpoint the product category, price range, and customer industry categories that appear to be the most profitable for our company.

This step, therefore, consists of selecting a series of specific prospects for purposes of conducting extensive design specification interviews. We work out a detailed technical interview form to determine the performance specifications various types of customers are most likely to buy. This type of survey, and even the method of conducting it, can vary widely depending upon the product under consideration. Some of our questionnaires have run to ten pages and required two- to three-hour interviews with design engineers, purchasing agents, sales managers, and distributors. In this research we should come up with facts on product design that will reduce to a minimum the danger of developing unsalable or low-profit products.

Meanwhile, the product or brand manager (in some companies a committee) is constantly consulting with the production department to determine the practical problems

involved in manufacturing the products that the customer appears to find most attractive. The purchasing department is consulted to determine such factors as the availability of the needed material and components or the possibilities of the substitution of more favorably priced materials. The financial department is consulted, first, to estimate the cost of the proposed new product and, second, to determine the investment in terms of machinery, plant, inventories, and accounts receivable that will be required to market the product in the estimated quantities. Eventually, the final product design will be determined.

As pointed out above, all of these functions are performed repeatedly and checked out with the customer through the sales force and/or the marketing research department. The product is then tentatively priced. Often this price has been set by the marketing research findings at the beginning of the project.

*The Marketing Plan*

The marketing department then develops an integrated plan for selling the proposed product. This means determining the advertising strategy, the media strategy that will implement the advertising strategy, the promotional tactics, and the publicity. It also determines the best sales organization and its selling tactics and finally, in the case of technical and industrial products, the size and type of sales engineering service required. All of these functions must be carefully integrated into a balanced and detailed plan and often written up into a month-by-month calendar of activity.

During the preparation of the marketing plan, pricing is finalized and may be quite different from that set during the product development stage. In any event, pricing becomes the result of compromising between what we would like to sell a product for and the price that will sell the optimum amount of goods at a satisfactory profit.

*Distribution*

When the marketing plan has been developed, the physical distribution of the product is carefully planned to ensure having "the right product, at the right price, at the right place, at the right time, and in the right quantity." This calls for carefully coordinating production schedules and warehousing strategy with the sales program.

The final result should be the movement of the planned amount of product to a satisfied customer at an optimum profit to the company. For many companies, "satisfying the customer" means servicing the product after he has purchased it to ensure that he will buy again and recommend the product to others. Then, the procedure starts all over again with marketing research finding out how well he likes the product and what can be done to improve its salability and reporting this information back to product development so that the company can either improve or innovate. The most important principles to keep in mind, as stated earlier, are: first, to determine customer needs and desires; second, to coordinate all of the company's departments in order to develop and produce the product, and third, to integrate all of the marketing functions to sell this product to a satisfied customer most efficiently.



## ORGANIZATION

A company can organize in an almost unlimited number of ways to operate under the marketing concept. In the last analysis, the organization must be the result of careful consideration of such factors as the type of industry, the nature of the particular company's business, and the personalities and capabilities of the executives.

The marketing concept will operate best in those companies that have a sound basic organizational concept. Consequently, the company itself must be organized in a practical manner and its marketing department competently staffed. Duplicating the Proctor & Gamble organization chart or the General Electric organizational chart may

be just the wrong thing to do. Barrington Associates, Inc. points out the need for a more meticulous organization planning job in the foreword of one of their brochures: "The current shift from a Sales Management to a Marketing Management concept increases substantially the number and complexity of the problems and decisions facing the Division's Chief Executive. He is more than ever before, a key member of the Top Management Group, and he must be capable of thinking, planning and administration of the highest order. For that reason, it is imperative that the Vice President-Marketing's job be analyzed meticulously, and that his basic function, his major responsibilities and key duties be stated in the most precise terms. When this is done, he is in position to delegate the component responsibilities and authorities specifically, and to follow through regularly and efficiently to insure their effective performance by his subordinates.



"Such a position analysis must be carried out in greater depth than is usually the case for a conventional 'Job Description.' "[1]

Every company, to avoid trouble, should take an objective look at its particular job requirement, develop a job description containing clearly delineated duties and responsibilities, and then draw up a "man specification" before rushing out to hire a man or to promote one from within.

Once the basic concepts of the organizational requirements are clearly in mind and man specifications have been developed, the next job becomes that of filling in the blocks on the preliminary organization chart. This should be done with men possessing the proper combination of executive ability, technical marketing competence, and personality. The final definitions of duties and responsibilities should wait upon the selection of the men so that the written position descriptions will be a realistic blending of personalities and capabilities along with the required duties and responsibilities.

One major error that should be avoided if possible is staffing "from the bottom up." In this situation, a new organization chart is developed and the company fills all or most of the positions before it hires a director of marketing or a department head. Trouble develops when the new top man finds his subordinates are incompatible, or his prehired department does not have the proper balance of ability and personality.

By very definition, the coordination and integration required in today's marketing concept requires constant and intimate working relationships among all corporate top-level executives. While the marketing director must be sufficiently aggressive to hold up his end of the corporate give-and-take, as well as see that the jobs within his division get done on time, he also must be sufficiently flexible to get along with executives and subordinates alike. All these characteristics and experiences must be evaluated in relation to the job to be done and in relation to the personality of the corporation.

### TYPES OF DIRECTORS

Here are excerpts drawn from several professional sources of the main specifications for three basic types of marketing directors:

*A True Director of Marketing*

" . . . The basic function of this position is to: plan and manage *all aspects of the marketing program;* maintain and equip a well-trained organization to carry out the program; and direct all marketing operations so as to attain stated objectives within company policy and budgets.

"Major Responsibilities:

1 Sales Planning and Policy
2 Sales Organization, Training and Compensation
3 Sales Forecasts, Quotas, Budgets and Controls
4 Selling Operations
5 Industry and Customer Relations
6 Pricing
7 Advertising, Sales Promotion, Publicity and Public Relations

[1]Barrington Associates, Inc., *The Kind of Executive Needed for the Position of Vice President—Marketing* (New York, 1957), p. 1.

8 Product and Market Research and Development

9 Sales Operations Research

10 Employee Relations."[2]

Then there is another type of position often called director of marketing but which is more accurately called:

### *Director of Marketing Services or Marketing Planning*

"Basic Function . . . responsible for administering, coordinating, and controlling all aspects of planning the total marketing program for his assigned product lines and *for assisting the sales organization* in successful implementation of the program. . . .

"Specific Responsibilities:

1. To develop and recommend for approval of the Vice President a complete marketing program pertaining to his assigned product lines, including a factual analysis of the markets, an enumeration of problems and opportunities, specific marketing objectives, advertising and promotion plans, packaging and brands, selling methods, forecasts of sales, cost of sales, and profits for at least the ensuing year.

2. To direct the Product Managers in conducting similar marketing planning activities for the assigned products.

3. To organize and chairman planning meetings of representatives from Research and Development and from Production, together with the Product Managers, for purpose of expediting the development and production of present products as well as the coordinated development of new and improved products. . . .

. . . . . .

6. To work with Finance and accounting in providing recommended budget estimates and accounting controls necessary to determine the profitability of present products and methods of marketing, as well as to measure current marketing performance in relation to objectives.

7. *To work with the General Sales Manager* and the Regional Sales Managers in the development of all aspects of marketing planning. . . ."[3]

[2]*The Kind of Executive Needed for the Position of Vice President—Marketing*, p. 2.

[3]From a report prepared by Bruce Payne & Associates, Inc. (Westport, Connecticut, 1958).

### *Director of Marketing—Multidivisional*

A third type of marketing director most often is employed by multi-divisional corporations who normally have autonomous marketing or sales departments for each of their divisions. This type of marketing director functions primarily as a corporate coordinator and marketing consultant.

"As vice-president of marketing, the successful candidate will report directly to the president. Primary responsibility is the co-ordination, in a staff capacity, of all sales and related activities among twelve autonomous manufacturing and sales divisions. The vice-president of marketing may have acquired a broad knowledge of sales methods and market research as a top staff man in a company producing both consumer and industrial goods, or as a management consultant. He must be able to recognize and cure duplication of sales or allied efforts between divisions without creating friction. He must act as the profit center conscience of the entire company's distribution system. He must be highly creative and have the ability to use all the knowledge gleaned from divisional sales personnel to benefit the company's over-all planning and scheduling."[4]

## PRODUCT MANAGER

A product manager has been variously described as a "little marketing director" or even as a "little president." Actually some of these men are not so little.

In many companies product managers are delegated nearly all of the marketing services responsibilities of the marketing director for a specific brand or product line. Generally, he does not have responsibility for sales. He is in effect responsible for developing his brand or product line into its most salable form for the sales department.

In some of the very large consumer goods companies, several product managers may report to group product managers, who in turn report to the director of marketing.

[4]Ward Howell, "Marketing Managers Wanted: Big Rewards, Key Responsibilities for Right Men," *Printers' Ink*, CCLXII (March 21, 1958), 61.

### *Market Manager*

A modified version of the product manager is called a market manager. This position is established when market conditions indicate that specialized knowledge of customer problems and buying habits is much more important than specialized product knowledge, in other words, where there is even greater need for customer orientation than for product orientation.

In some companies, a market manager may be responsible for the planning and/or sales of many, if not all, of the company's products sold to his designated market. (Two obvious examples for American companies are export sales and military sales.) The responsibilities of a specialized type of market manager are described in an article by the sales manager, Home Products Division of the Minneapolis-Honeywell Regulator Company:

"During the fifteen years prior to 1948, our company sold temperature controls in the schoolhouse market. There was no special product which could be assigned to this field, but the market was large for our broad line. The divisional executives in charge of this operation decided to appoint a man to the job of 'Product Manager.' He was assigned no product, but he was given a market. He was charged with the broad responsibility of securing more business in this field.

"It was our thought that a 'market' manager would operate in the same general staff sales assignment as a product manager, but with the advantage of being oriented to the customer rather than to the factory. This plan sought to consider the problem in customer terms wholly, and to try to fit the company's products and the company's sales methods to the market.

"The distribution of controls in schoolhouses is simple, following the classic construction industry pattern. An architect draws plans, and heating contractors bid for the work. Our business had been bidding as a subcontractor (with installation included) and we very often found that a low price was not the answer to securing the contract. Instead, the new market manager decided that three things were necessary:

1. Improved installation and service.
2. A direct-to-user public relations campaign.
3. Retaining of sales force to sell the owner.

"As a second step, a school expert, recognized in the field of education, was engaged to consult and advise on an industry relations program. This man recommended orienting all communications to the market in terms of educational values. Advertising and sales promotion which had been directed to contractors were now addressed to the ultimate user, the school system. Management was taught to recognize educational objectives and to design and use our product to meet these objectives. The sales force, in turn, was taught how to speak in terms of educational goals and, in so doing, removed a large obstacle to successful sales calls.

"Almost overnight, a service which had been sold on a strict price basis to engineers and contractors became a shining new service in the interest of education. We found that a mundane set of devices actually could produce a 20 per cent improvement in the take-home learning of the average student when properly appiied—and with this knowledge came an astounding preference for our product.

"One of the important bonuses gleaned from this campaign was the improved selling power of the sales force, when equipped with bona fide customer benefits and nomenclature. In the past seven years, sales have increased many times, and we have seen a new potential for our schoolhouse market. And without a market manager—the possibility of solving a real problem through specialized marketing thought and action would have been lost in the vast welter of other divisional business."[5]

TO SUMMARIZE, I should like to emphasize again that the most important ingredient

[5]R. H. Jacobs, "The Effective Use of the Product Manager," in *Strengthening the Sales Organization* (Marketing Series No. 97; New York: American Management Association, 1956), pp. 19-20.

necessary to make the marketing concept work is the corporate state of mind.

For any company to operate efficiently under the marketing concept, top management must understand that the integration of all of the marketing functions and the coordination of the marketing work with all the other corporate functions are absolutely necessary.

Another "must" is customer orientation. We have to design, manufacture, and sell products that the customer wants and then offer them to him not the way we would like but the way he wants to buy them. Furthermore, we must organize to do all this at a profit!

More and more companies are going to have to bring in more and better marketing techniques such as marketing research, package design, advertising and sales promotion, motivational research, and the like. Also, they must be carefully coordinated with each other to prepare the most salable product to attract the customer. A carefully planned organization is necessary to ensure that these coordinated plans are actually developed and carried out.

## THEORIES OF ORGANIZATION

PAUL J. GORDON

AT LEAST four important definitions of "organization" can be distinguished in America today—each signifying a somewhat different approach to the subject. The differences, of course, are not quite as compartmentalized as any arbitrary scheme of classification might suggest.

The *traditional* view of organization emphasizes some logical arrangement for dividing the work. The emerging *behavioral* view, having outgrown its earlier immaturities, stresses a system of cooperative relationships. The newer *decisional* approach focuses on the study of an organization as a decision-making unit. (Here we meet a semantic problem inasmuch as decisions cut across all these approaches.) This third view could also be called a systems approach, provided we reject the older image of systems as a bundle of office procedures and accept the newer view, which relates organizational systems to unified arrangements of interdependent factors, such as the solar system. The fourth approach we shall call *operational*, because the term may appeal to marketing executives. It emphasizes how the organism responds and adapts to its environment. This is not too far from the thinking of grass roots customer-orientation suggested by more recent marketing management concepts.

According to the traditional view of organization, the task of organizing is that of establishing relationships among the work, the people, and the workplace. The criteria to be used in organizing are certain well-established principles of organization, such as unity of command and homogeneous assignment. The anatomy of organization, according to this view, is composed of elements such as authority, responsibility, accountability, hierarchy, chain of command, and span of control. The function of organization is to promote effectiveness (achieving desired goals) and efficiency (doing so without waste). The ways of dividing work at each level of organization involve combinations of decisions on the basis of the functions to be performed (for example, marketing, finance, and production); the processes involved (for example, refining oil in different categories of complex, technical, and expensive equipment); professional groupings (for example, all creative people or all lawyers in one organizational unit); and, the products, the clientele, or the area to be served. The last criteria named are not only closely related to one another but also represent increasingly popular bases for dividing activities in larger companies that use the divisionalized form of organizational structure. In summary, the traditional view is work-centered; organization is regarded as a technical problem to be solved on a highly rational basis; the influences that have shaped it are eco-

nomics and engineering, and, in the case of public administration, law.

In contrast, the behavioral view is that the task of organizing calls for establishing relationships among individuals, groups, and somewhat dark and ominous things called formal organizations and bureaucracies. Recent literature suggests that the executive concerned with organization should choose those arrangements, broadly speaking, that are most likely to evoke a system of effective cooperative relationships. Given the behavioral approach, the building blocks of organization include individual and group feelings, perceptions, motivations, inducements, and interactions. From the managerial point of view, the function of organization is to facilitate suitable combinations of social support and social constraint for the main activities of the enterprise in order to achieve essential conformities and coordinations. Individual and group views may lead to informal organizations that may either advance or retard the purposes of the enterprise. Organization is regarded primarily as a social system and one that develops interactions, conflicts, and cohesions not always within the power of the executive to understand or control. Organizational decisions involve various combinations of individuals, groups, social structures, bureaucracies, and institutions. In contrast to other approaches, the behavioral view of organization centers on people and their problems, and executives should extend their efforts to understand and evaluate nonrational as well as rational aspects of organizational behavior. Two main academic disciplines that underlie this approach are psychology and sociology.

The decisional or systems view of organization is more sharply concerned than the earlier ones with the establishment of relationships among objectives, strategies, and competition. The criterion is achieving objectives under competitive conditions. The structure of decision-making and the building blocks of organization in this view include information, objectives, strategies, alternatives, probabilities, and consequences. The function of organization is to facilitate the flow of information and the making of appropriate decisions. The executive faced with organizational decisions must choose among combinations of ends, means, strategies, tactics, and informational inputs and outputs. This approach is decision and systems centered; information, including that about competitive forces, is regarded as a central problem, and certain aspects are more highly analytical. Mathematics has already made an important contribution to this approach. Political science, however, which is concerned with relative power position, representation of diverse and competing interests, and ultimate accountability, is still relatively untapped as an important wellspring for organizational theory.

The operational view, as defined for this presentation, is concerned with the establishment of relationships among the organism (in this case the firm and its marketing components), its environment, and whatever vitalizing forces regulate interdependent adaptations and changes. The criterion is ability to respond to changing environment and opportunities for growth. Growth here does not have to mean increased size; it could mean diminished size with greater strength, competitive ability, and return on investment. This view is more eclectic (borrows from all the others) and heuristic (ready for readjustments of ends, means, and behavior anywhere along the line in the light of new discoveries). To put the matter less abstractly, here we have an approach that starts with the grass roots, for example the customer, as a focal point and then adds the necessary operational elements—stealing along the way from the so-called principles, the notions of cooperation, and the strategies of competition in order to bring into concert the organism, the environment, and change. According to this view, the organization functions as a catalyst, facilitating growth and change.

This approach is probably closer to the "new look" in marketing than some of the earlier ones. The executive confronted with

organizational decisions would seek the most appropriate combination of customers, outlets, territories, and institutional channels for his products and services. He would also seek the best balance between frequent organizational changes, which might harm desirable relationships, and undue concern for stability in organizational relationships, which might lead to atrophy. This balance is sometimes called "homeostasis." The operational approach, as defined, is growth centered, regards viability as the key issue, and is environmentally—even culturally and cross-culturally—oriented. The last point especially has significance for executives sensitive to international aspects of marketing. The studies upon which one might draw more fully in developing this approach would include biology and anthropology.

WHAT DOES all this mean? Why is it important, and how can executives put these insights to work in some productive way? The material may not be entirely new. Mine may be simply another perspective and another way of classifying organizational knowledge. For some of these viewpoints, I must acknowledge a debt to people in the field of marketing. Nevertheless, consolidation of gains can be useful, and an up-to-date knowledge of developments in organizational theory can prepare one for the future. The traditional and the decisional approaches and the behavioral and operational are not quite as diverse as this analysis might suggest, and they appear to be coming closer together. Further, one may perceive that characteristically the traditional and behavioral approaches have been more concerned with organizational arrangements internal to the firm, the operational with adaptation to external environment, and the decisional with combination of internal and external factors.

This brings us very close to the task of the executive himself. Executives generally must be concerned with ends, means, behavior, and results. Marketing executives must be concerned with externals as well as internals to a greater degree than executives in some other areas. International marketing executives must add the extra dimension of the cross-cultural and multi-national environment. What distinguishes management among other forms of human activity is the responsibility of seeing that decisions are made and actions taken that will achieve desired objectives. The organizational task of the manager is to build and maintain the interdependent systems of cooperation, information, and technology that are essential for the achievement of these objectives and the continuity of the organization itself. This activity requires that the manager use such tools as forecasts, plans, and research in order to navigate his firm in a competitive environment.

WHAT OF the future? In addition to these theories, what trends do we see and what practices can we expect in the field of organization that may be important for international marketing executives? Many of the organizations that we represent are more concerned with suitable development of a divisionalized form of organization (based on product, area, and clientele) and provision of adequate supporting staff and technical services for each division than with new approaches to organization on the basis of function. This change of emphasis means that organizations become more involved in working out suitable relationships among general division managers (who have operating line authority) and specialized program and product managers (who have functional staff authority relative to their programs and products). The more traditional attention to line versus staff conflicts, for example personnel versus production, becomes relatively less important or is delegated to lower levels, somewhat the same thing.

More emphasis may be expected in the future on the development of multinational forms of organization even including foreign policies for the navigation of multinational enterprises; even smaller firms will be less inclined to compartmentalize thinking and forms of organization into domestic and for-

eign sectors. Strategists responsible for organizational planning will be more attuned to external orientation, less preoccupied with exclusively internal orientation, more concerned with making organizational change a normal state of affairs, and less interested in organizational stability as a virtue in itself. We shall pay more and more attention to the development of indigenous talent for our overseas managers and "export" less of our own. At the same time, however, in developing executives for our home enterprises, cross-cultural facility will become more important in many top positions than cross-functional experience within the company.

Future emphasis in practice and in the literature will be more on evolving the best mixture of centralization and decentralization, and less on the idea that decentralization ought to be pursued as an end in itself. People must recognize that various sectors of organizations can be centralizing and decentralizing at the same time otherwise confusion will result. Decentralization refers to moving the power and authority to make and to execute managerial decisions away from the center, that is away from the top executive and the headquarters office. It has been called moving general management down the line.



Closely related to the centralization/decentralization question are three matters that now occupy the attention of many American companies. We see developing an emphasis on the use of staff experts as "experts on tap," to be called on as resource people, rather than "experts on top," an added set of inspectors to haze line executives. The technology of information as a relatively new potential, with new machines to process information, will probably receive a great deal more attention; the technology of production will probably receive comparatively less—at least, that is, less top executive time. Even in the factory, while mechanization continues to be important, the potentials are in the automatic control systems for many companies. Another aspect of decentralization, may be the easing of control in order to increase creativity, initiative, and productivity through a more delicate interplay of freedom and control.

Finally (and here more than elsewhere aspiration may be mixed with prediction), more attention to objectives and to the scaling of ultimate and intermediate values that underlie any choice of ends, means, and behavior may be anticipated. Institutions that are primarily economic in their purposes will have to create economic utilities, social institutions will have to create social utilities, and political institutions will have to strengthen desired governmental arrangements. The point in this context is, however, that we may see more effort made to deal operationally with the multiple and frequently conflicting objectives that characterize many of our institutions and provide ulcers for many executives. With no intentional deception, simplified objectives may be retained for general public and employee consumption. The objectives of business enterprises, however, are many and complex. This means that future emphasis may be more on values, especially for international people, and less on methods. In addition, it means that large institutions will be more concerned with representing a diversity of viewpoints and seeking what unity is needed not in uniform viewpoints but in common objectives insofar as possible.

The closing point is that in our study and practice of organization we shall become less concerned with prescriptions to cover all situations and more concerned with developing knowledge of organizations based on sound predictions. The advance of knowledge and the important executive decisions must be based on this approach.

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## A FRAMEWORK FOR EXAMINING ALTERNATIVE MODELS OF MARKETING ORGANIZATIONS

FREMONT A. SHULL, JR.

THE STATEMENT has been made that the market dictates the characteristics of a distributive organization as well as the properties of the merchandise offered for sale. However, this unadorned proposition offers little insight into the complex and enigmatic problems of designing a marketing organization. The solution to such problems requires more than a "proper" orientation. Organizing demands the application of certain operational criteria and strategies. Yet concern with marketing includes problems of interaction with client groups as well as problems of interaction within the firm. Hence, a mechanistic application of some standard format, especially one designed for a production department, is contrary to reason. Accordingly, neither a simple market-orientation nor the application of traditional principles of organizing seems sufficient. Moreover, these two approaches appear to be in polar positions with a void between them. The purpose of this presentation, therefore, is to attempt to describe a framework that will penetrate this void.

Insight into organizational problems is improved if the organization is viewed as a total system composed of multiple subsystems, each individually and collectively having characteristics of a society interacting with other social groupings. This system, as an entity, is a "black box" containing many unknown relationships and phenomena within which various linkages must be developed and maintained. A functional view of the organization can now be grasped that discloses networks of relationships and a set of potential outcomes for each action, rather than singular causalities and unilinear stimulus-response connectives. Implementing these human linkages, then, necessitates optimizing, not maximizing, decisions and precludes the disposition to accept a linkage as an end rather than a means for goal attainment. All of this leads to an acceptance of the possibility of dysfunctional outcomes of particular organizational patterns and techniques, and a search for a larger array of significant internal and external variables relevant to the construction and operation of the system.

The elaboration of each of these elements would require a tome of its own. The black-box concept can be used to exemplify the ramifications involved. In this concept, learning is encouraged that elicits a flexible and uncommitted attitude that precludes an unbinding acceptance of, or an *ex post* accommodation to, the outcome of a particular administrative action. In addition, learning permits heuristic problem-solving. This approach reduces the tendency to concentrate upon algorithmic solutions to restricted quantitative problems that may answer only

tangential disturbances or reinforce the original issue. In this light, noncommitment can develop as a strategy relating to administrative functions (intrude learning into the control system) or operative behavior (ensure continuous vigilance and flexible behavior).

Use of the black-box concept (the idea that the internal workings and interrelationships of the organization are not fully known) encourages abstractions from immediate concern with operational activities to broad, general reflections about, for example, the amount of natural chaos in group endeavor and the social propensities of man in the work environment. The varying assumptions made about such considerations produce diverse conclusions and, therefore, require different general models for organizations. Furthermore, the black-box concept, which is usually provided for in a systems approach, calls for consideration of exogeneous factors that influence endogeneous features and phenomena. Accordingly, attention is focused upon the cultural setting within which the organization operates. This observation is significant since the culture influences the acceptability of, and priorities given to, organizational objectives; it also places constraints upon the means that may be employed to gain these ends. More actively, the culture molds the nature of the human input, including the capabilities of the operative personnel and the orientations of top management.



SUCH A perspective invites far-reaching insights for the model-builder who is implicated in organizing in a mix of cultures. International marketing requires an assessment of the social role of the economic environment. In certain countries, a "good life" may not give high priorities to material welfare; organizational success and individual motivation may not relate primarily to financial gains. On the other hand, a society may encompass a dynamic and developing economy within which the individual firms are growing rapidly and, thereby, offering expanding promotional possibilities within the managerial hierarchy. If such is the case, growth may be prerequisite for a particular organization to attract and retain adequate personnel.

This vision illuminates problems associated with another basic issue, the definition of the survival ends of an organization and the relative weights to be assigned them. From their recognition and specification, inferences concerning related internal sufficiencies can be made. First, since business firms utilize resources other than members' talents and interests, long-run political and economic tolerance requires that the needs of a certain clientele—other than those of active members—be served. Organizational productivity is thus a relevant goal that is reinforced by the development of a highly refined free enterprise and competitive economic system in many cultures. Second, bidding for membership time and effort is important where conscription cannot be practiced and where real alternative choices of employment exist. Therefore, the satisfaction and loyalty of the personnel is a survival need that varies in nature and intensity according to prevailing morale and ethical beliefs. Finally, since an organization operates in some larger environment, it must adjust and perpetuate itself through external political, economic, and social disturbances. Thus, the ability of an organization to endure stress in situations, that is, maintain its own integrity, is a third significant survival end.

The priorities assigned to these ends will determine the techniques used to influence internal arrangements and behavior. High-stress conditions, such as violent changes in the political climate, tend to add weight to organizational integrity and, hence, to those techniques that enhance group cohesiveness and prompt reaction on the part of operating personnel. If such is the case and if channels between point-of-sale and policy-making are extensive, feedback must be emphasized and/or considerable decentralization must be induced. Suppose, however, that the salesmen become dissatisfied and frustrated

without detailed and specified operating procedures and that their morale is an end worthy of consideration. Therefore, if the integrity of the organization is to be maintained, a feedback system is of utmost importance. If, on the other hand, salesmen have independent and mature personalities, decentralization would appear to be appropriate. In contrast, managerial imperatives may suggest that satisfaction of the operative employees is trifling and should be dominated by increased integrity and performance.

The resolution of such problems depends in part upon the answers to the following questions: Are performance, morale, and integrity of equal order and independent of each other, or are they points on a means-end chain? Will higher morale, for example, actually elicit a corresponding increase in performance, or are they outcomes related inversely or positively in some diffuse or direct manner to the same administrative and organizational technique? Empirical studies offer conflicting evidence on these questions; this conflict suggests that the organizing process be somewhat experimental so that the total puzzle can be investigated over a period of time.

Without this multiple-goal orientation, simple-minded maximizing behavior may hold sway, which precludes a balanced attainment of the long-run survival needs. Formed upon the bureaucratic efficiency rationale, traditional prescriptions framed solely for downward flows of authoritative communications may set in motion a chain of dysfunctional outcomes in terms of feedback and growth of individual salesmen. The orthodox chain of command may be structured for and may elicit a dependent and immature type of employee response. This type of response contributes to the view that salesmen are apathetic, ignorant, and contrary. Such an interpretation can result in further reliance upon autocratic and manipulative leadership patterns by operating supervisors that magnify the puppet type of selling behavior. To the extent, then, that salesmen want to express themselves and that autocratic leadership reinforces the view of superiors as a part of the disciplinary as well as communication system, feedback—especially appeal—channels will form outside the lines of authority.

Although organizing is multifaceted and philosophers recognize that the surplus accruing to organized endeavor results from social interaction itself, tradition apparently concludes that organizational creativity stems exclusively from job specialization. The logic seems to hold that, since social relationships are naturally chaotic, the saving grace of an organization is the formal imposition of a "grand design" for behavioral relationships, especially one designed to secure the benefits of specialization. This reasoning concludes that organizations should be built around jobs and not around people. This deduction is buttressed by the argument that organizational continuity requires a functional, not personalized, schema—individuals will be gone in the next few decades, but requisite activities are everlasting.



THESE CONVENTIONAL derivations persist despite evidence supporting the contention that latent properties of an organization cannot be legislated against, relate to the natural behavior of man, and can promote formal organizational purpose. Current practice illustrates sporadic and isolated instances of a counterapproach, for example, the "buddy system" and "brainstorming" sessions. But custom does not typically lead to the thought that conventional tactics of formalization may be debilitating and actually create disorder; or, if it does, such disorder is treated as a natural phenomenon that can be dissipated by additional formalization. Thus a fresh, holistic approach may disclose that an overemphasis of formalization, particularly that based upon specialization, may hinder organizational effectiveness.

Although treated incidentally, continuing reference has been made to the nature of the human input, the salesmen. These inputs will

vary by such factors as average age and temporary societal conditions according to:

**Expectations**—salesmen do (not) anticipate the receipt of intrinsic job satisfactions or the satisfaction of certain social needs during work hours but do not (do) expect authoritarian supervision. Thus, reliance can (not) be placed upon extrinsic benefits to be exploited outside the work environment, that is, wages, and (not) upon a high level of participative management.

**Aspirations**—salesmen are (not) favorably disposed toward administrative detail and do (not) perceive advancement in the organizational hierarchy as a means for self-aggrandizement and satisfaction. Accordingly, a formal promotion system is (not) an incentive basic to increased performance while training should not be (be) restricted to immediate job proficiencies.

**Capabilities**—the general experience and intelligence of salesmen is (not) great enough to absorb a high level of decentralization. Therefore, an organization should not be (be) designed to exploit the bare spark of men's creativity and abilities, as contrasted to a broad range of human potential and energies.



Against this background, the side effects as well as target effects of administrative action can be examined. Suppose that potential, rather than the lack of operative ability, dictates the establishment of a training program, but at the same time, centralization is demanded that must be facilitated by job simplification and standardization. While training and education tend to expand horizons and raise aspirations, centralization and simplification may well create boredom and discontent. Thus optimizing and timing become of paramount importance; each can be guided by the priorities assigned to the survival ends of the organization as well as the nature of the human input.

While cultural assistance and controls—for example, state ownership or subsidy schemes—affect the social consciousness of a microunit, the orientation of top management will determine the specific reward system of an organization. Assuming a causality between operative morale and performance and/or morale and organizational integrity, and given a set of needs of operative personnel, positive sanctions will depend upon the following points of view: (1) means for answering these needs only outside the workplace should be provided, (2) the workplace should provide all possible extrinsic and intrinsic satisfactions, or (3) administrative action should focus upon the temporarily essential or most sensitive needs at any point in time. Any conclusions drawn will serve in tailoring the design of the organization and its formal reward systems.

Throughout this discussion, the situational aspects of organizing have been touched upon but have not been treated explicitly. Certainly the size and maturity of a firm determine the impact of various organizing techniques. While self- and/or imposed control is inherent to efficient operations of a small organization, its nature and implementation will differ from that of a large organization. In large bureaucratic organizations, control is commonly informal and exercised on an impersonal basis. Similar distinctions can be made for most phases of organizational behavior. Planning for adaptation and flexibility, for example, differs from planning for guidance and stability. Whereas such comparisons illustrate the caution that must be utilized in forecasting or generating organizational phenomena, certain general relationships can be ordered and approximated, if not completely measured and predicted. The change from voluntary to compulsory membership, for example, would have some impact upon the sanction system employed. An organization confronted with the problem of recruiting members who have alternative choices, may find that subordinates react more fully to positive inducements than negative sanctions.

Fear of the unknown and emotional attachments to convention appear to retard exploration and veil real causalities. Traditionalism, for example, suggests that the most powerful "manipulative" technique is economic remuneration. Yet empirical evidence indicates that man's mediation process intrudes itself between a change in wages and a conventionally conceived, automatic change in behavior. To state the problem Simply, an increase in wages may not stimu-

late a corresponding change in performance; the inaccuracy and incompleteness of perceptions and the operation of aspirations between reward and satisfaction are considerations in anticipating man's response to changes in financial rewards.

ALTHOUGH THE nature of this presentation has forced undue emphasis upon certain propositions, the viewpoints, concepts, and assumptions described require examination before the traditional and more mechanical problems of organizing are treated. The designer may find solace if he considers only the formal structural relationships of an organization, especially those founded in the rationale of economic efficiency supported by assumptions pertaining to administrative sagacity and prerogatives, or spatial dispersion and buying habits of purchasers. Yet the contention is made that the behavior of people and their satisfactions are not circumscribed by such constraints nor do organizations prosper and endure under such strictures. There is no doubt that the preparation of this work would have been expedited had the intent been to describe operational techniques supported by traditional principles of organizing. But the typical business organization does not maximize accepted goals of charitable organizations, nor are military organizations designed to operate like a hospital. Furthermore, an organization built around needs of a production unit will not necessarily facilitate marketing effort.

The purpose has been to build a framework for judging alternative models of marketing organizations. This framework has been a simplified cybernetics model, encompassing the black-box concept, superimposed upon a behavioral point of view. While marketing orientation has been accepted as necessary, such a posture was judged insufficient for dealing with the reciprocating relationships at play about an organization and the operational requirements of the organizing process. No pretense has been made that organizing is easy or that the design is permanent, for the lack of theoretical models or constructs and the paucity of empirical evidence cloud the issues and temporize the resolutions; in addition, the situational features of the problem make the test doubly formidable, becoming artistic in nature.

This over-all approach has conceived of the organization as a totality including multiple linkages and their interactions, such as authority, appeal, and decision networks. This view has also disclosed the differing elements of the organization—its technical, economic, and social aspects. Although complexity was added, these sweeping but differing insights into organizational problems should offer profound but varying concepts of the configuration and provisions of the dilemma. If credence can be given to the constructs offered above, success seems to lie with an open mind, intensive analysis, planned noncommitment, controlled experimentation, and unrelenting effort. If all of this be true, it may be necessary to pursue the unknown, perceive and evaluate differing assumptions, and register and trace the progress of alternative organization models under test.

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# MARKETS: RESEARCH

## THE MARKETING MANAGEMENT CONCEPT — IMPLICATIONS FOR MARKET RESEARCH

Wallace O. Yoder

The term "marketing management" has been interpreted in so many ways that one more attempt to give it precise meaning probably will not hurt. The approach to the concept presented here involves five simple assumptions about the firm, a restatement of the marketing function, and the application of four subconcepts in the performance of the marketing job.

A statement of the assumptions under which business firms operate will make explicit the conditions that affect the attitudes and actions of those concerned with the decisions and operating problems of managing the business enterprise. These assumptions are implicit in most instances, but stating them will help set the stage for the interpretation of the marketing management concept.

*The Commitment of Capital.* Every business organization involves a commitment of capital in the form of money and other assets. This capital is essentially risk capital in that once the commitment is made, it is difficult to withdraw. Ownership of undivided portions of the capital can be transferred, but actual withdrawal of capital from the firm rarely takes place.

*The Perpetuity Assumption.* The day-to-day, month-to-month operations of most business firms are conducted as though they were to be carried on forever. This attitude is characteristic of managers, employees, suppliers, and customers, and becomes a vital factor in an attempt to formulate a working marketing concept.

*Profit as a Primary Objective.* The characteristic common to all firms is that they were organized and continuously operate with the expectation of augmenting the capital originally committed to the enterprise. That is to say, the dominant objective of all business enterprises is the acquisition of profit. This motivation is so universal that a business is called a nonprofit or nonbusiness organization if other motives are dominant in an organization to which capital has been committed.

*Something for Sale.* Every business organization has something for sale. The firm expects or attempts to increase its original capital through the sale of its offering to customers at such prices and in such volume that the total revenues exceed the total expenses incurred.

*Revenues Relative to Costs Incurred.* Every item of cost or expense involves a commitment of the firm's capital. Some commitments are hopefully regarded as temporary, while others must be regarded as permanent or semipermanent because recoupment from revenues must be spread over long periods of time. This suggests one way of considering costs, namely whether or not the commitment can be regarded as being functionally related to output and revenues. This is the fixed-variable way of looking at costs.

This view leads to a consideration of incremental relationships between costs and revenues, and to the general rule that any addition to total cost should be made only if revenue additions larger than the added cost can be anticipated with a high degree of certainty. In other words, in considering the acquisition of additional revenue, the cost commitment necessary should be less than the anticipated revenue. Given this assumption, it follows that, between two alternative incremental expenditures of equal size, the alternative which will yield the largest increment of revenue has first preference.

### FUNCTIONAL AREAS

The marketing management concept recognizes the existence of three major decision-making areas: finance, production, and marketing. The finance function is concerned with the acquisition of additional capital from outside sources, with allocating resources to specific functions and subfunctions within the firm, with measurement of performance of the whole firm and of sections of the firm, and with distribution of profits to owners. The production area's primary tasks are the preparation or acquisition of the firm's offering and preparation of the offering for sale. The task of the marketing area is "establishing, maintaining and expanding relations between the firm and its customers which will result in sales in such volume and at such prices that total revenues will exceed total costs."

Specifically, the marketing function centers around the marketing program, which involves seven correlated parts:

1 The offering of the firm
2 Prices at which the offering is presented to customers
3 The channels of distribution and the institutions through which goods are made available to customers
4 Advertising and promotional programs
5 Direct personal selling activities
6 Credit policies
7 Logistics of supply of product.

These seven elements interact so intricately with each other in the marketing function that no single element can be altered without affecting the others.

### THE MARKETING JOB

At the maximum operative level, the task of the marketing area is to provide direction for every function of the firm. Thus no decision will be made without consideration of its possible impact upon the effectiveness of the marketing function. In view of the interrelation among finance, production, and marketing, any decision on the budget, product change or design, or pricing or credit

policy that will clearly impair the firm's marketing operations will be made only when other considerations are imperative.

A firm adopting the marketing management concept as a basic guide to its operations will plan its marketing strategy and implement the strategy with appropriate tactics. Its profit goals and its marketing program will be planned in light of its market situation, which involves customers and potential customers, competitors, and its own man-power and financial resources. It will consider cost and revenue relationships particularly from the incremental point of view and will evaluate budget proposals on the basis of opportunity costs.

### *Subconcepts of Marketing Management*

As the marketing management concept has developed, three subconcepts—customer orientation, market segmentation, and product differentiation—have become closely associated with it.

*Customer orientation* involves an attempt to view every aspect of the relationship between the firm and its actual and potential customers from the customers' point of view. The objective is to eliminate aspects of the marketing program that impair the differential advantage which the firm may have achieved and bolster those parts that enhance it.

*Market segmentation* is a concept that develops logically from the idea of customer orientation. When the relationship between the firm and its customers is surveyed from the customers' point of view, it quickly becomes apparent that different customers have different problems and therefore perceive the relationship between the firm and themselves in different ways. When the members of a group of customers are sufficiently alike in their problems and can generate a large enough volume of sales, it may be profitable to treat them as a separate market segment and to provide a marketing program in whole or in part designed to give the firm a profit advantage.

*Product differentiation* is a term that has been in the vocabulary of economics and marketing for over a generation. The original implication was the altering of a general product in minor or major ways to achieve specific identification of the product variation with the individual firm. Under the marketing management concept, this original implication has been extended to involve not only differentiation from other firms but differentiation toward particular groups of customers.

## MARKETING RESEARCH

Implementation of the marketing management concept places a premium on more and better information for those who must plan and execute the marketing program. Information is required for setting specific goals and subgoals, as well as for making decisions on the various parts of the program.

Faster and better feedback of market information and of the result of current operations is also required so that weak spots may be discovered early and unexpected opportunities exploited more completely. Information may also be needed to formulate remedial action. Information requiring special attention includes forecasts of total product demand, share of market analysis, relative potentials for market segments, and analysis of sales, gross profit, costs, and contribution to overhead and net profit by product line and by market segment.

General information is required about the whole customer-firm relationship, including the part specific products play in the lives and work of customers and competitive strengths and weaknesses of the firm. Much of this involves a thorough understanding of consumer behavior.

Detailed knowledge of customer reaction to products, brands and packaging, pricing, and of customer action at point of purchase becomes vital to developing marketing programs. Similarly, much more information will be required to develop effective advertising programs and other forms of promotion.

## MARKETING AND THE BEHAVIORAL SCIENCES

STEUART HENDERSON BRITT

THIS DISCUSSION of the relationships between marketing and the behavioral sciences will be limited to the overlap between marketing on the one hand and psychology, sociology, and cultural anthropology on the other. These are the areas that are most interesting to present-day marketing men who are already grounded in other social sciences such as economics.

The degree of overlap between marketing and the behavioral sciences may be exaggerated somewhat by many men in marketing. Marketing practitioners and marketing teachers are likely to think that there is a tremendous body of knowledge in the behavioral sciences which can be lifted out and applied to marketing problems. Actually, specific materials applicable to marketing must be searched for, and there is the additional problem of applying these materials to specific marketing problems. One reason for this difficulty is that most behavioral scientists are not business oriented. Many of them, in fact, are antagonistic toward business problems.

The fundamental job of the behavioral scientist, if he tries to carry on truly scientific work, is to satisfy his curiosity by experimental, observational, and statistical methods that will advance knowledge, but these results will not necessarily produce results having practical application. Otherwise, this negative aspect is part of his job. Many behavioral scientists prefer to do pure, rather than applied, research.

When materials useful to marketing men are found in the literature of the behavioral sciences, they may be utilized in two ways, both involving what psychologists call transfer of training. The material may be applied in solving a specific problem—in this case the facts are transferred. Or the material may be digested and may affect the attitudes of marketing men—in this case materials are transferred attitudinally.

In spite of these limitations, however, marketing men should be acquainted with a variety of subjects discussed in social-science literature. These include such topics as social mobility, role expectations and subcultures, occupational specialization, persuasion, conformity, personality, stereotyping, imagery, culture, motivation, leadership, and communication. This material exists in books, monographs, and articles, and in many different languages.

The marketing man must decide which materials can be used with reference to topics in marketing. For example, there is little or no material in the social sciences applicable to transportation, storage and warehousing, wholesaling, or channels of distribution. However, a great many ideas from the behavioral sciences are helpful in gaining a better understanding of consumer motivation, consumer behavior, product development, and all phases of nonprice competition. This does not mean that marketing will become a science of human behavior, but that marketing can use psychological methods—scientific, observational, and statistical techniques—to a greater extent than ever before.

Aside from the practice of marketing, which is largely an art, some aspects of marketing might eventually become the basis of a science of "marketology." This science would include a vast array of information that could be catalogued and used as an aid in future marketing decisions. A fundamental problem is the differences in attitude between behavioral scientists and those in marketing. The sociologist, psychologist, and anthropologist have a long history of research studies that marketing people do not. Behavioral scientists, unlike those in marketing, have a tremendous body of theory and are divided into various schools of thought. Behavioral scientists use scientific methods, whereas marketing people in general do not. The intent of the behavioral scientist is tc

advance into new frontiers of knowledge; marketing people are more interested in analyses of what is current. Behavioral scientists are concerned with explanation, marketing people with description. Wherever possible, behavioral scientists tend to be quantitative; marketing people generally do not, although there are exceptions in the case of marketing research.

There are many significant areas in the behavioral sciences that should be investigated by marketing men. In the future, greater use than ever will be made of the materials from these disciplines, and marketing men and behavioral scientists will cooperate considerably more than in the past on problems of mutual interest.

## THE APPLICATION OF RESEARCH TO ADVERTISING

JOHN S. COULSON

JOHN WANAMAKER is reported to have once said: "I know half of my advertising is wasted, but I don't know which half." Most practitioners today agree that much advertising is far less efficient than it can or should be.

Advertising research is in the same position; far too much of it is wasted. There are several reasons for this. In many cases, the research has not been carefully related to the problem. Researchers and their clients, the advertising men, do not have the problem clearly in mind and do not understand exactly how research will help them solve it.

The advertising man and the research man in advertising should put in far more time and energy defining and redefining the problem at the start of the job. They should work together closely so that they are completely satisfied that the research will answer the questions, instead of being satisfied with interesting but not particularly pertinent information. They must force themselves to answer the question: Exactly how will I use this information and is it worth the money it costs? Paul Gerhold, of Foote, Cone, and Belding, suggests asking a further question: Will the advertising that results from use of this research be more effective than it would be if the creation and approval of the advertising were the result of judgment alone? If you can answer these questions, you can proceed with confidence.

The second reason for waste in advertising research is that research is not integrated closely enough with the process of creating the ads. Timing is essential. Research in advertising must start at the very inception of the development of the basic selling strategy. A tightly integrated research program is needed that proceeds step by step, one premise growing from another, until a strong fabric of information is developed, which makes it possible to interpret each new piece of research intelligently.

A program of research that will help develop better advertising will include research to make sure the advertising fits the company's or brand's market problems. This requires a careful examination of all facets of the economics of the market and the brand's position in the market, including such questions as:

1 Where would any new business come from—competitors, other products, new consumers, people who now use the product using more of it?
2 How profitable is the product? Is it one that is worth pushing?
3 What jobs is the advertising expected to perform — getting and maintaining distribution, stimulating salesmen, maintaining promotion, building company reputation?

Research should also define the market so that the advertiser can direct the advertising to the right people. Who, in terms of age, sex, social class, education, geographic location and city size, and race uses the product? Who are the heavy users? Who buys? Who influences the purchaser? Who are the people who are most apt to switch brands? Locating the target market affects not only the media and the message to be used in the advertising but also any future research.

Research should attempt to find the strongest message about the product that can be delivered by the advertising. The following steps should be taken:

1 An analysis should be made of the physical product itself, its origin, history, chemistry, physical characteristics, components, design, manufacturing process, and packaging. An analysis should also be made of competitive products to determine real differences.

2 A study of consumer attitudes about the product—real or imagined advantages and disadvantages—should be made.

3 A study should be made of consumer's behavior with the product—how he uses it from the time he sees it on the store shelves to storing it at home and preparing it, using, and disposing of it. This will tell how advertising can better integrate our products into the consumer's life.

4 The social factors related to the product, the kinds of people the consumer sees using the product, and its brand image should be investigated.

5 The relevant symbology of the product should be established.

Research should be carried on while the advertising is being developed. Here speed and flexibility are essential, since creative people work quickly and are intolerant of delay.

Research undertaken before an ad is run should make reasonably certain that each ad or commercial has the intended effect. This, however, is where most research fails. The harsh fact is that we cannot predetermine the selling effectiveness of an ad or commercial before it is run. However, we can speculate as to how advertising works. This may be done by means of a two-part model consisting of what is said (the message) and how it is communicated. Research on advertising before it runs seeks to answer not how much product the ad will sell, but how the advertising performs in terms of its attention value and its ability to communicate, and how well the message is retained.

The final step in an advertising research program takes place after the advertising has run and seeks to determine how well it does in the market place. The ultimate measure of advertising is sales. However, for many products, sales are affected by so many factors other than advertising that clear relationships between advertising and sales cannot be found, even with the most sophisticated operations research techniques. As a result, success is determined by surveys measuring changes in awareness, consumers' attitudes, and buying intentions and behavior.

Much advertising research is wasted because of the problem of communicating research findings. Advertising is an extremely complicated process. Research on advertising often fails because it is either oversimplified or overcomplicated. Obviously, both these dangers must be studiously avoided.

One final point regarding the creation of advertising: As Burnett says, "Eventually, someone has to get out the ad." It is very difficult to produce something that is at the same time fresh, provocative, interesting, and pertinent, and that will sell merchandise. We cannot engineer great ads, although we can engineer safe ones that copy other safe ads. Engineering an ad is based on deductive reasoning, but the essence of creativity is inductive reasoning—finding new relationships between ideas. J. Bronowski, an eminent British scientist, recently stated:

> "We expect artists as well as scientists to be forward-looking, to fly in the face of what is established and to create not what is acceptable but what will become accepted. . . . A scientific theory cannot be constructed from the facts by any procedure which can be laid down in advance, as if for a machine. To the man who makes the theory, it may seem as inevitable as the ending of "Othello" must have seemed to Shakespeare. But the theory is inevitable only to him; it is his choice, as a mind and as a person, among the alternatives which are open to everyone."[1]

A truly creative person should not be fenced in with research rules and procedures, but nourished with facts and information. The only requirements should be that his ads do what he expects them to do and fit the needs of the market.

[1]J. Bronowski, "The Creative Process," *Printers' Ink* CCLXXIV (Jan. 13, 1961), 26-27.

## THE APPLICATION OF RESEARCH TO SELLING AND SALES PROMOTION

JOHN S. COULSON

MY INTEREST in the field of research in selling and sales promotion is built on the firm conviction that advertising does not work in a vacuum. Despite the tremendous power of advertising, there is much more to moving merchandise than merely advertising it. This is true in self-service, and it is even more true in the so-called shopping goods.

Many years ago, in studies on appliances by McGraw-Hill, it was estimated that a good floor salesman could persuade more than 85 per cent of the customers who came in to buy an appliance to switch brands. We have done several studies in this area by placing our investigators on the appliance sales floors to act as salespersons and to observe what takes place.



According to these studies, the housewife who usually shoulders the job of picking the brand of an appliance does not understand its mechanism. Neither does her husband, though he is less quick to admit it. It is no wonder that style and design are so important, for here, at least, is something the husband can have an opinion about. I am told, however, that there is considerable worry even on this score. What Dichter calls the "misery of choice" is heightened by the fear of making a mistake, of getting stuck with a lemon.

As a result, the prospective buyer asks his friends, looks at ads, or perhaps goes to consumer reports. Generally, the consumer tries to shift the burden of responsibility. He is, our psychologists tell us, looking for an authority figure, and for a great many people, the best authority figure, certainly the most available, is the floor salesman.

However, the customer feels that he cannot trust the floor salesman altogether. When interviewed, the customer says that other people may be influenced by smooth-talking salesmen, but that he makes up his own mind on the basis of inspection and information. This is not the case, however. The customer does not want information; he wants evaluation. At some point in the sale, the salesperson is asked for his opinion on which appliance is best.

Occasionally the customer comes into the store knowing exactly what he wants, although more often than not he has more than one acceptable brand in mind. He makes up his mind sometime during the selling period. Often, he tests the salesman; he asks questions about the merchandise, and will also check the salesman's motives, looking for evidence of his sincerity and trustworthiness. If reassured, he will make friends in order to get the salesman on his side and deal with him on a personal friendly basis. After convincing himself that the salesman is his friend, he will take the salesman's advice.

Because of the crucial role of the salesman, manufacturers are spending large amounts of money to convince salesmen of the merits of their products, and many organizations make regular checks to see how they are progressing in this area. The standard mechanism for measuring progress is the shopping survey. Field investigators are sent in to pose as customers and report on how the salesman steers them. On some occasions, male and female investigators work together, posing as man and wife. This has proved to be most successful because salesmen realize that a woman alone is not ready to complete a sale. A regular annual or semiannual shopping survey can be a very worthwhile project.

In addition to researching the retail situation from the point of view of the manufacturer, it is well for the manufacturer to listen to complaints from the retailers about himself. This procedure is called a trade survey, and is often run in conjunction with shopping surveys. The purpose of the trade survey is to determine how the trade is reacting to a firm's marketing policies, as compared with the policies of a competing firm. Some of the elements usually covered relate

to product attitudes (operation, design, service, durability, and consumer appeal), sales effort (coverage, how well the salesman tells his story, and frequency of call), promotional activity (PM's, Spiffs, and consumer promotions, display materials, display allowances, and contests and deals), advertising activity (cooperative advertising, local effort, and amount and quality of national effort), pricing and margins, and company reputation. Although this is a partial list, it contains more than all dealers will supply.

Trade surveys have been found to be most successful when those making the survey work in pairs. The surveys are kept on an informal basis and are frequently scheduled for lunch or a coffee break.

Other techniques for gathering data include mail and phone surveys. We have conducted several mail surveys and have found that, with the proper incentive (a small premium), we can get as many as 30 per cent returns. We have also conducted surprisingly extended interviews by phone, calling long distance from Chicago to dealers throughout the country. Cooperation is excellent, and this method is far less expensive than sending trained investigators to the stores.

Research on sales promotions should not be neglected. In the mass merchandising field, a major measurement of point-of-sale materials is whether or not they are used. It has been said that as many as half of the major point-of-sales pieces distributed never see the light of day in the stores. Another area for sales promotion research is the effectiveness of store display materials in terms of their visibility. We have made studies on point-of-sale materials similar to display studies.

Contests are an important selling device for many of our clients, and we have occasionally had the assignment of determining in advance which of several contests was best. Two elements qualify for research in analyzing contests: the prize structure and the nature of the contest itself. Self-liquidating consumer premiums is a very old area for research. Here we ask for alternative premiums, present them to potential customers—people who send in for premiums—and ask for a selection. We view these tests as a practical, speedy, rough screener.

Price promotions and other special inducements present a different problem. The question here is whether they lead to additional business or merely replace volume the brand already has. The best information to work with is family history information from consumer panels; from it, we can determine who bought promotion merchandise, whether they did or did not buy in previous periods, and whether they did or did not rebuy after the deal was closed.

## THE APPLICATION OF RESEARCH TO PRODUCT DEVELOPMENT



EDMUND W. J. FAISON

IN THE evolution of a new product, research plays an important role from the first glimmer of an idea to the final question, "Shall we go ahead and market it?" Even then, the marketer cannot sit back and relax. The product must be continuously appraised in the market place to forestall trouble caused by changing tastes and by new competitive products.

The basics of research for domestic and international marketing are the same—the consumer is the guinea pig. However, since the attitudes and tastes of the guinea pig vary not only from country to country but from area to area in any one country, research must be conducted in the proposed or actual marketing areas of the particular product.

The first step in the development of a product is the development of ideas. Ideas can come from anywhere, and preliminary screening of rough ideas is usually done on a judgment basis. When several product ideas have been selected, research can be called on to evaluate them.

The first step in this secondary screening is making a rough estimate of market potential. In considering a new flavor of cake mix, the following questions might arise: How many people eat cake? How many of these use cake mixes? Is the new flavor generally a favorite? If the product concept has an apparently profitable market potential, it is then subjected to marketing research coordinated with technical product research. In this process, preliminary consumer testing of various formulas or designs takes place. In the case of a new automobile design, for example, photographs or scale mock-ups can be taken to the consumer for testing attitudes toward the alternative designs. Design distinctiveness can be tested with laboratory instruments such as the flash meter or tachistoscope. Taste tests and blind product-use tests can be used for testing alternative product formulations such as in foods or toothpastes.



Once the formulation or design of a new product is fairly well set, the evolution of marketing strategy begins. This includes selection of a name ("Cape Cod," for example, might be a good name for a seafood product but not for a candy bar) and decision on the basic advertising and sales promotion approach and the package design (the package design is part of the advertising). Marketing strategy also includes deciding on distribution channels and selling strategy.

Test marketing is the next step. For the first time, the product is put into actual buying conditions. Test marketing procedures are used not only to find out if Mrs. Jones will put out money for the product, but to find out from Mrs. Jones if she is sufficiently satisfied with it to buy it again, and these procedures will also reveal any wrinkles in the formula, instructions for use, or promotion, which could be eliminated before national distribution is undertaken. If the product survives this test, preparation for full-scale introduction is begun. This involves all departments of the company from production and advertising to finance and involves close cooperation among them.

Following national introduction, a close watch must be kept on sales and, in addition, advertising and consumer research must be continued. Research is no crystal ball operation. Predictions of consumer interest—and purchase—can never be 100 per cent accurate. The most carefully researched product can fall flat on its face because of a change in consumer tastes or a change in competitive products.

There is no standing still in marketing. The producer of a product must continually move ahead or fall behind, and research is the best insurance that he will move ahead. Research is particularly important for companies selling internationally. The snowballing importance of self-service in Europe, for example, increases the importance of prepackaged advertised goods. However, many an exporter has found out to his financial pain that what is acceptable in one country in product, package, and advertising approach is unacceptable in another country with different tastes and customs. To be effective, research must be conducted in the market in which the product is to be sold.

An example of the variety of acceptability is the fact that see-through plastic packages are well accepted in England, but considered in France as cheapening the product. Cookies, for example, once plastic-packaged in France, are now wrapped in foil. Differences, too, result in some difficulties with names. Names that are totally innocent in one country can have unpleasant connotations in another. There are also differences in eating habits—for example, the French eat pastries, not cake.

Marketing research know-how is very advanced in Europe—on a par with the U.S. Exporters would do well to consult with a local marketing research company before making any attempt to market a packaged product in a European country.

## THE APPLICATION OF RESEARCH TO PACKAGING

EDMUND W. J. FAISON

THE PACKAGE design is of great importance in marketing mass-produced products: It is the point-of-sale advertisement. It provides the last sales talk and instructions for use, and it competes directly with the products of other companies.

Package design research is very useful in determining the success of four key characteristics:

1 Visibility—Is the package easily distinguished in the visual competition of actual shelf display?
2 Content communication—Does the package quickly signal the nature of its contents?
3 Psychological connotations—Does the package have an image that is consistent with the product marketing strategy?
4 Function—Is the package easy to open, to close, and to store? Does it adequately protect its contents?

Package design research cannot tell how to produce the best package. There is no "best" package. If it was decided that the ideal label for a can of beans was black printing on a white oval against a red background, and all bean canners packaged their beans thus, the result would be utter confusion.

Package design research makes only comparative measurements. Beware the package design research group which offers conclusions that go beyond the data. Sound research will not come up with a recommendation such as, "Make the background yellow and your package will be better."

The visibility of a package design when it is in competition with other brands is of great importance. Mass display impact can be measured both in stores and in the laboratory. In in-store tests, the product in one design is placed in one group of stores, another design in another group, and records are kept of purchases. To speed up results we sometimes use a forced sale coupon test, in which coupons good for, say $ .20 off on a product category, are handed out at the entrance to a supermarket. In one such test, one package design for a frozen Chinese food outdrew another design by more than 50 per cent.

Find-time tests are another technique that can be used in a store. The subject is given a shopping list and timed on how long it takes to find a particular product. Photo techniques are also very useful in determining mass display impact. For example, movies taken from a moving base view supermarket shelves just as a shopper might as she walks through the store. Viewers of these movies are asked to recall what brands they saw. Another photo technique utilizes color slides of a product category—some of package design "A," some of "B"—which are flashed before groups of respondents. Again, respondents are asked to recall what they saw.

Content communication is measured by various techniques. One is to flash a photograph of a product and ask what it contains. In such a test of a cake flour package, 84 per cent of the housewives in the test thought it contained a cake mix. In another case, an uncooked spaghetti was thought to be a heat-and-serve product by 93 per cent of the respondents.

Even though a package rates high in mass display impact and clearly indicates the nature of its contents, it can fail for other reasons. The psychological connotations—or image—created in the mind of a consumer by the package design can make or break a product. A paper napkin package might be both visible and communicative yet fail to connote softness—if softness should prove to be an important attribute.

A variety of tests, ranging from simple paper-and-pencil check-off tests to depth interviews, is available to determine the psychological connotations of a package design. Since the psychological connotations of a design must tie in with the desirability of a product's attributes, both must be tested. A useful preliminary to this type of testing is

the group interview in which housewives or some other group are encouraged to talk freely about a product category. If the subject, for example, is paper napkins and softness as a "good thing" is a factor, the relative importance of this attribute can be determined in later research. If softness turns out to be an important factor, then the package must connote softness, and perhaps even feel soft.

In addition to these mass display, content communication, and psychological connotation research techniques, laboratory instruments are used to measure legibility and visibility of individual elements of a package design. These instruments include the following:

1 Angle meter—Packages are often viewed at an angle from a supermarket aisle. At what angle can a package be recognized?

2 Threshold illumination meter—This instrument tests the readability of type faces by systematically blocking out the amount of light falling on a package. The less light required to read a word, the more legible it is.

3 Color-form meter—Systematic blurring of a package, as seen through the viewer, measures the strength of a design. Highly contrasting colors and definite shapes hold their visual identity better than complicated or delicate designs.

4 Distance meter—This instrument measures the distance at which a package can be recognized or various copy elements read.

5 Apparent size meter—Of two packages of identical size and shape, one may appear larger because of design. This instrument measures the apparent size.

6 Angular reflectance meter—Visibility resulting from "shine" is tested in this instrument, which compares different designs and materials at all angles of reflection.

7 Design dominance meter—Alternative designs are placed in this instrument so that the viewer sees one design with one eye, the other design with the other eye. The two designs are superimposed by the viewer's vision, and the more dominant design will be "seen." Alternating the positions of the packages eliminates dominance caused by the relative strength of the viewer's eyes.

Package function can be tested in homes. If instructions are difficult to understand, or the package annoying to open, or slippery when wet, these points should be discovered before the product goes on the market. Package function can also be tested with such devices as a hidden camera that records the degree of difficulty of opening various types of packages.

This is a somewhat sketchy run-down of package design research techniques. Even if time permitted a complete listing and explanation of all the tests currently used, that list would be incomplete by tomorrow. In our own company, for example, we continually devise new techniques for special problems. In addition, none of these tests is sufficient in itself. No one test or set of tests can be applied indiscriminately to any given package design problem. Previous information and experience must be considered before research techniques are selected for a project.

Nor are tests all that is needed. Judgment must be used both in evaluating the results and in making decisions based on the results. Research results guide the manufacturer in deciding to discard, modify, or keep an old package, and in choosing between alternative new designs. They also serve as a guide for the package designer. Package design research is no "this is what you should do" service, but it is invaluable as a guide to cutting the risks involved in marketing a product.

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# PRODUCTION PLANNING

## SUMMARY

JOHN F. MAGEE

NOT TOO many years ago, production planning was of little interest to marketing people. Today, however, many marketing men are coming to recognize that production planning is important in the total logistic problem of producing and distributing goods successfully in competitive markets. Our discussions here are concerned with the elements of this problem—the plant's supplier, the various stages of production, and the channels of distribution to customers.

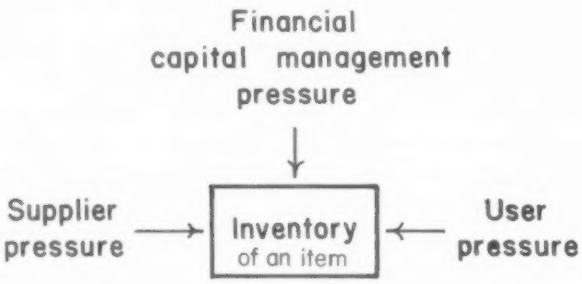
The subject of production planning could be approached from various points of view—procedures, organization, or policy. We should not concentrate entirely on any one of these, but should consider each one in its relationship to the total logistic problem. While organization, procedures, and "hardware" are all important in production planning, the concept of production planning as a process is most important. This process should be designed to determine what, how much, and when to produce in the light of market opportunities or forecasts.

### PLANNING FUNCTIONS

The first concept central to the production planning process is that of an inventory or a stock of an item. An inventory is a buffer or cushion that absorbs pressures arising from various sources in the business. The inventory interrupts the physical flow from supply to use, permitting more flexibility and economy in the flow of goods. The inventory tends to absorb shocks or pressures arising in adjacent stages of the logistic sys-

FIGURE 1

**Pressures on Inventory**




tem. In Figure 1, pressures are shown arising from the supplier and the user sides of the inventory as well as from the financial side (capital management).

On the supply side of an inventory, pressures are normally in the direction of increasing the average size of the inventory. If the item is purchased, economies of quantity buying and incoming freight charges, as well as receiving, handling, and paper-work costs, encourage larger and fewer orders. If the item is produced, the economies of larger and fewer lot runs also result in pressures for a larger average inventory. On the user side, too, the pressures arising in the competitive marketplace tend to increase the average size of the inventory in order to provide quick service to customers. This is true regardless of where the inventory is in the many stages of supply from the dealer back through field and factory warehouses and production stages.

Finally, offsetting the supplier and user pressures that tend to increase the average size of the inventory is financial pressure from above. Inventory is an investment that carries with it ownership costs. While it turns over more rapidly than investment in equipment, nevertheless, the inventory is owned at all times, and it has a carrying cost that must be reckoned with. Inventory must compete with all other assets for the company's limited supply of capital.

The major function of the production planning process is to achieve a reasonable balance between the three sets of pressures bearing on inventories throughout the various stages of production. Furthermore, these production stages are followed in the total logistic system of supply by the stages of distribution represented by regional warehouses, field warehouses, and dealers selling to the ultimate user. Effective production planning must take into account the pressures exerted on the production stages by the distribution stages. In attempting to achieve a reasonable balance between the conflicting pressures exerted on inventory, production planning reconciles marketing and production with financial objectives and interests.

## THE NATURE OF INVENTORIES

Inventories perform various functions and may be classified according to function performed.

*Process inventories* must be on hand to fulfill user requirements while additional stock is being purchased, produced, packaged, or transported.

*Organization inventories* "buy" organization—the more of these carried between stages in the manufacturing-distribution process, the less coordination is needed to keep the total process running smoothly. However, if inventories are already being used efficiently, they can be reduced only at the expense of greater organization effort and cost, that is, greater scheduling effort to keep successive stages in balance, and greater expediting effort and cost to eliminate the difficulties that unforeseen events may cause.

Despite superficial differences among businesses and the characteristics of organization inventories they maintain, three types of this inventory are basic.

*Lot-size inventories* permit flexibility in the operations of the supply side and the use side of the inventory by separating these functions. These inventories exist wherever the supply side wants to buy or produce in larger amounts than the user needs. The

fixed cost of acquiring a lot of any size creates pressure to acquire large lots in order to write off this cost.

*Fluctuation inventories* exist wherever there is a delay in the reaction to changes in user requirements. Customer service may be maintained in the face of delayed supply by carrying this type of inventory, which is frequently called safety stock. The greater the delay in reacting to changes in user requirements, the larger the safety stock should be. Also, the greater the maximum deviation from mean expected user requirements, the larger the fluctuation stock should be if user service is to be maintained.

*Anticipation inventories* provide for anticipated fluctuations in user requirements. Examples include goods sold in seasonal markets, goods for which materials may be only seasonally acquired—for example, tomatoes for canning—or a surge of output for simultaneous sales promotion in widespread markets.

In all of these types of inventories, the various pressures from the supply side, the user side, and from financial management must be reconciled in the production planning process.

## THE RECONCILING FUNCTION

A general discussion on organization for performing the reconciling function brought out several points.

*First,* a central organization unit with authority to make reconciling decisions in both the production and distribution systems would practically run the company, particularly if this unit had authority to decide physical capacities at all production and distribution stages.

*Second,* companies tend to hold to the classical division of marketing, production, and finance organization units and expect the units to work together where necessary to accomplish the reconciling function. This may be done through formal communications, through committee action, or informally. In any case, the prerequisite for successful reconciliation of pressures is an understanding of all factors involved and how they operate in support of over-all company success. Thus, training of the decision-makers in each of the three classical organization units is essential. All of the decision-makers must understand the central questions involved: What is the cost of customer service failure? How fast can production react to changes in user requirements? How much production organization, or precision of control, can be achieved? How much is capital tied up in inventory worth?

The answers bear directly on the main question: How much should be invested in inventory to best reconcile supplier and user pressures?

*Third,* the following points were made in a discussion of the appropriate level of a central organization unit: The level should be quite high, but the exact location would depend to a great extent upon full understanding of the central questions and the cooperativeness of the executives to whom this production planning group reports. Disagreement at any level would have to be resolved by the executives at the next level.

*Fourth,* if it does not have authority to make decisions on the physical capacity of the various stages in production and distribution, the organization unit will successfully operate at a lower level in the management group.

*Fifth,* the level at which the central production planning unit operates may change with time. When first set up, it may report to top management, if only for the purpose of bringing the issues to top management attention for prompt policy decisions. Once top management is fully cognizant of the issues and policies are established to cover them, the central planning unit may report to a lower level in the organization. Much depends upon having personnel with the appropriate skills in the central planning unit, and upon top and lower management's having confidence in the unit. Evans' description

of the growth phases of the central planning department for his company's fourteen glass plants illustrated these points.

*Sixth*, in a company where the chief operating executive's background and principal interest are in one of the basic functions, such as sales, it may be necessary for the central planning unit to report to a committee composed of those in charge of production, marketing, and finance, which reports directly to the chief executive. In this way, there is greater assurance that all pressures will be appropriately reconciled.

*Seventh*, whenever the pressures cannot be resolved at one level, the real contribution of the central planning group is in providing information on the costs of alternatives for higher-level decision.

William L. Naumann, vice-president of Caterpillar Tractor Co., who has administrative direction of the nine domestic plant operations, made the following points in describing his company's production planning process:

1 Plant end items, including original equipment such as tractors and attachments, are scheduled by a central planning group at the company's main offices. Replacement parts are scheduled by a central planning group in the Parts and Service Division.

2 Piece parts required to meet plant schedules are scheduled at the plant organization level—in other words, this scheduling is decentralized.

3 The centralized product scheduling function is initiated by a Department of Business Research.

4 Plant master (end item) schedules are developed by the business research group, which works with Naumann's office to level individual plant loads while reconciling the various pressures on inventory. Plant manpower plans are established by this process.

5 Reconciliation of the various conflicting pressures, stressed earlier as the central function of the production planning process, is accomplished by consultation with the various organization units involved, such as finance, employee relations, sales, and industrial relations. In a sense, the organization chart is thrown away. The chiefs of all organization units concerned are familiar with the problems requiring reconciliation, are in close proximity to each other (communication channels are short, informal, and effective), and have proven their ability to work together.

Discussion of Naumann's comments centered on policies concerning centralized purchasing and avoiding increased overhead charges caused by scientific planning and control. The main points in this discussion were as follows:

1 A centralized purchasing group in the company places orders for all nine plants on certain standard materials to be shipped directly to these plants. All other materials are acquired by each plant's decentralized purchasing group operating according to general policy established at headquarters.

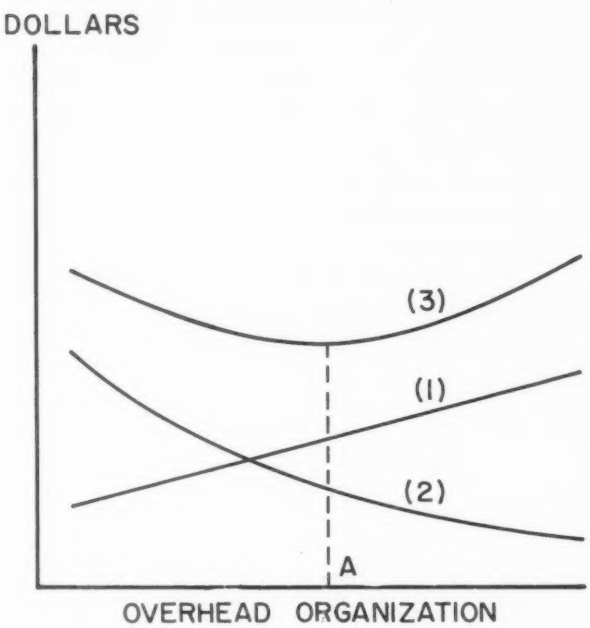
2 All major purchased items are under frequent review to determine whether local or centralized control is desirable. It is difficult to generalize about centralized versus decentralized procurement of items. The final decision on each item usually turns on conditions unique to that item. The important point is that the status of each item be reviewed frequently, since conditions change often in competitive supply markets. This means keeping close touch with supply as well as use conditions.

3 Concerning increasing overhead charges for more scientific production scheduling and control, including the use of mathematical models, it was pointed out that National Industrial Conference Board studies yield strong evidence that the higher overhead costs of American firms result in higher productivity, which means that total cost per unit of output is no higher than in European firms. The total cost per unit of output is the relevant measure. Figure 2 illustrates the economics involved.

The problem described in Figure 2 is one of finding the amount of organization effort (overhead) that will result in lowest total

FIGURE 2

**Organization Effort (Overhead)**




A—Optimum organization (overhead)
(1)—Cost of organization effort (overhead)
(2)—Total direct cost
(3)—Total cost (1 + 2)

cost. More overhead cost (curve 1) will usually result in lower total direct cost (curve 2). Total direct cost is the sum of direct manufacturing, selling, inventory carrying, and service failure (stock-out) costs. Up to a certain point, increased overhead cost will reduce total cost through improved productivity. Beyond this point of diminishing returns, increased overhead will cause total cost to increase.

4 The cost elements in Figure 2 can be found through a statistical treatment of accounting data but will usually shift with changes in the level of output, often making it costly to maintain up-to-date cost data. This, together with the fact that even a statistical treatment of data on service failure (stock-out) costs involves careful judgment, tends to lower the usefulness of mathematical models in production planning. The main point is that a full understanding of the philosophy behind mathematical models (and their graphic equivalents) will result in better judgment.

5 Evans presented his company's approach to the problem of forecasting and scheduling production of replacement windshields for old model automobiles. These are stocked at a large number of depots as well as at the producing factories, and service failures cannot be averted without carrying excessively costly inventories or, alternately, spending the time and money for a good forecasting and scheduling job. The department found a way to use available data on past automobile sales by year and model to forecast quite accurately the annual, as well as seasonal, demand for particular models of windshields. It was found that the large volume of data processing involved could be efficiently handled by an electronic computer. It is expected that this system will eliminate service failures almost entirely while sharply reducing factory and depot inventories.



## INFLUENCE OF FORECASTING

Four major points were brought out in discussion of the role of forecasting and its influence on the production planning process.

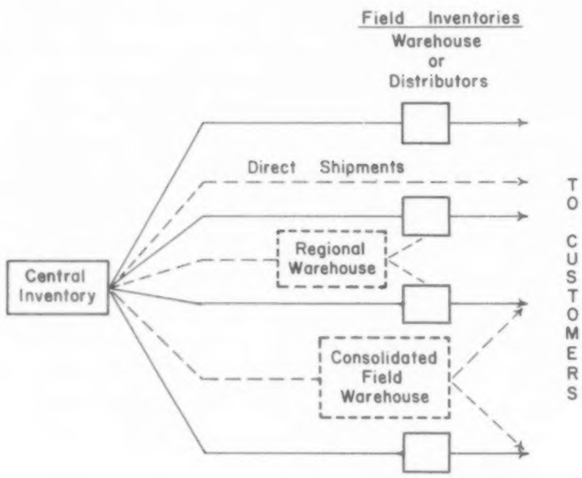
1 Although some in marketing insist that forecasts for the demand for their products are impossible to make, nevertheless forecasts are necessary and are made by someone in the company, if not by marketing personnel.

2 Since production or procurement takes time, someone must decide in advance of actual demand the amount that will be demanded, unless excessively costly stocks of all end items in the product line are to be carried to preclude stock-outs or service failure at higher than competitive rates. Capital management pressure will usually result in more emphasis on better forecasting.

3 The necessity for detailed forecasting of demand is diminished by flexibility in plant processes. This permits forecasting in terms of process hours rather than number of end

FIGURE 3

**Representative Distribution Systems**

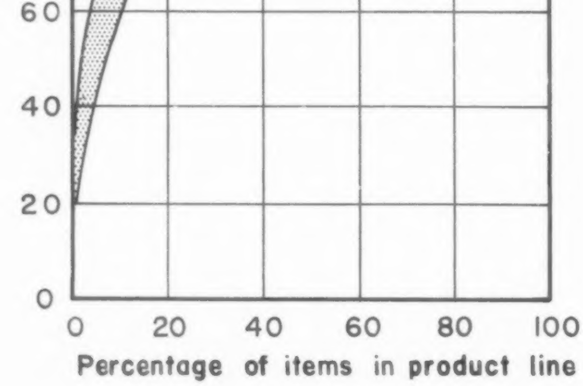



—Existing distribution system
— —Alternative distribution system



FIGURE 4

**Product Line as Percentage of Sales**




items. The former type of forecast is usually easier to make than the latter. And from the production viewpoint, all that is available for sale is production process hours.

4 A single-figure forecast is not enough for scheduling plant operations economically. A figure on mean demand must be accompanied by a figure on range or maximum reasonable demand, if service failure is to be held to a competitive level without excessively costly inventories. The word "reasonable" implies that judgment is involved. Statistical treatment of data on past demand fluctuations ought to be a powerful aid in making the necessary judgments.

## DISTRIBUTION SYSTEM

It was observed that discussion of the physical distribution system, including the contra-system of information flow, was a good means of tying together the elements of production planning and integrating them with the over-all marketing system. This subject might well be called "the logistics of distribution."

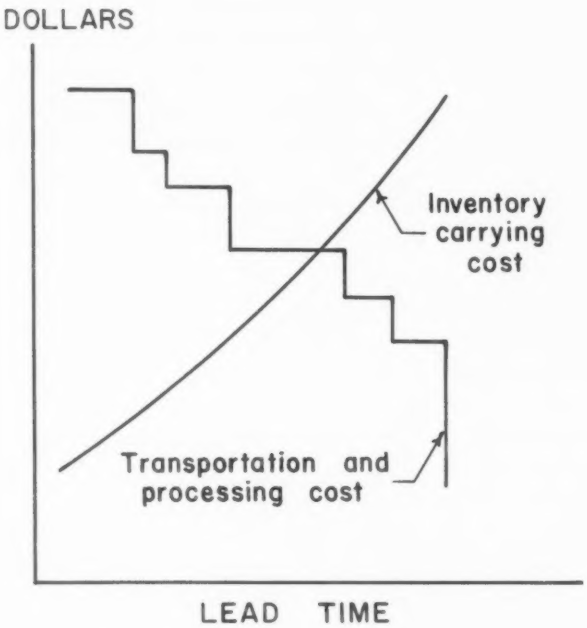
A representative distribution system, together with various alternative systems, is shown in Figure 3. One alternative to the existing system is the consolidation of two or more field warehouses or distributors. Another is the establishment of a regional warehouse (inventory) to service two or more field warehouses. Still another is the direct shipment of products from the central inventory—for example, the factory warehouse—to customers. An alternative not shown in Figure 3 would be to have more than one central inventory or factory.

The logistic problem consists essentially of choosing that alternative or combination of alternative distribution systems that maximizes return on total investment over the long run—or until market conditions change significantly enough to call for a change.

The inventories carried in the distribution system represent one investment. The op-

FIGURE 5

**Cost Elements of Distribution Alternatives**



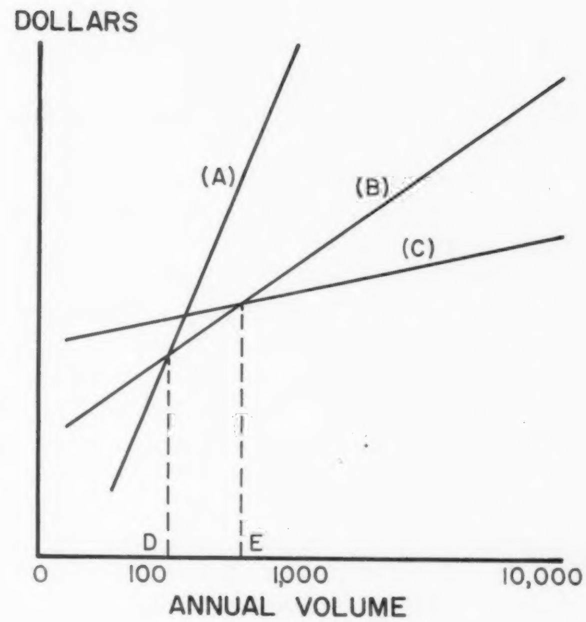

timal distribution system, as far as inventories are concerned, is one that minimizes the total cost of its operation. The variable costs of operation are costs of carrying inventories, transportation, customer service failure, communications (data gathering and processing), and changing manufacturing levels (supplying the central inventory).

An alternative not shown in Figure 3, and one that may be superimposed on all alternatives shown, is that of having some or all of the products in the product line carried at the various stock-points. Introduction of this variable into the logistics system complicates the problem considerably. Obviously, the longer the product line (or the greater the proliferation of products), the more complex the problem.

In dealing with the product line variable, it is useful to know the relative contribution to total sales of each fraction of the product line. The records of a large number of firms in the consumer and industrial products fields demonstrate that a relatively small

FIGURE 6

**Economics of Distribution**




(A)—Total variable cost of handling demand through central warehouse

(B)—Total variable cost of handling demand through regional warehouses

(C)—Total variable cost of handling demand through local warehouses

D—Break-even point between central (direct) and regional delivery

E—Break-even point between regional and local delivery

fraction of the product line accounts for a large fraction of total sales. Figure 4 reveals that, while 10 to 20 per cent of total items sold characteristically yield 80 per cent of total sales, half the items in the line account for less than 4 per cent of total sales. It is the bottom half of the product line that is responsible for much of the difficulty, expense, and investment involved in the distribution system. A complete analysis of the various alternative distribution systems for any company, including the portion of the product line carried at each stock-point, requires data such as that shown in Figure 4.

If the inventory of an item is transferred from a field warehouse to a central warehouse, transportation costs will rise if the

service level—and thus costs—is not to suffer. That is, a faster and normally more expensive form of transport, such as air freight, must be used. Warehousing costs and inventory investment may be reduced, however, as a smaller central inventory of the item will provide the same customer service level.

An important aspect of the logistics of distribution systems is the response or lead time involved in the system. The time requirements characteristic of all distribution systems are processing time, communications time, manufacturing time, transportation time, and cycle (review) time. The longer these periods, the greater the degree of error in forecasting over the total lead or response time and the higher the level of inventories required to cope with this error, given the permissible level of service failure.

Techniques of exponential smoothing of demand were discussed in connection with the derivation of a set of cost curves associated with various distribution alternatives. The alternative with minimum total cost can be determined from a set of curves such as those shown in Figure 5.

Finally, all the variables involved in the logistics of distribution can be brought together for a final decision through a process of analysis such as that represented in Figure 6.

The main point in the discussion of the logistics of distribution was that minimizing total cost is the relevant criterion, and all functional groups, such as transportation, production, and marketing, must be willing to raise costs whenever an increase will result in minimizing total variable cost. The tendency of each functional group to minimize the costs for which it is responsible often works against achieving minimum total cost. It would seem that only a central research group, combined with functional groups trained in the underlying economics of the whole system, could achieve this goal.

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# SALES FORECASTING

## INTRODUCTION

JACK R. WENTWORTH

BY ITS very nature, every company must perform some kind of sales forecasting if it is to survive in our dynamic economy. The value of this function to the firm will vary with the type of firm, its size, and its markets. Such factors will also determine the degree of accuracy that is needed in the sales forecast and this, in turn, will indicate the feasibility of establishing a formal sales forecasting unit. The firm with flexibility in such factors as supply, production, and inventory does not rely so heavily on an accurate sales forecast as a firm with less flexibility. Yet, to one degree or another, every firm must make some estimate of its future sales. This is even more important in this day of electronic computers, automation, and other technological innovations. Not only is the world today more complex, but it moves at a faster pace. Thus, a wrong decision based on an inaccurate forecast of sales (or worse yet, no forecast at all) will be more costly than ever before.

In its vital role in the marketing functions of the firm, sales forecasting is integrated with the other elements of the marketing mix. The sales forecast is used by the sales department in helping to determine quotas and in helping salesmen to do their job; the advertising budget can be better determined with the information from an accurate sales forecast. And so it goes with all the marketing elements.

Two general segments of accurate sales forecasting must be examined in any complete discussion of the subject. Since every firm must operate in our economic environment, the first segment is an economic forecast. The second segment naturally stems from the first and is, of course, the industry's or firm's sales forecast.

It should also be mentioned that two time periods are involved with both the economic and the sales forecasts. The problems of the short-run forecast, which is usually for a year or less, are quite different from those of the long-run forecast.

The need for sales forecasting is unquestionable; the boundaries of our technical knowledge about the subject are constantly being pushed back. Thus, it was inevitable that this subject should have become an integrated part of this seminar.

## SALES FORECASTING IN OUR ECONOMIC ENVIRONMENT

CHARLES L. SCHULTZE

FORTUNATELY, mine is the easy task in

today's program. I have not been assigned to discuss how to evaluate the outlook for the sales of particular companies, products, or industries. Rather, we are to consider some of the problems that arise in forecasting the level of economic activity as a whole. Such a forecast is obviously a prerequisite for judging the possible performance of one's own company. There is, of course, no neat mechanical relationship between the general business climate and the fortunes of individual firms and industries. It is precisely because there are so many ways in which an individual company can do better (or worse) than its industry—and the industry better (or worse) than the economy—that forecasting at this level is so difficult.

Nevertheless, particular forecasts must start out with an appraisal of the general level of business activity. The reasons for this are obvious. However efficient or inefficient and lucky or unlucky a firm may be, it must still hire labor, buy equipment, and sell goods under conditions that are heavily influenced by the general pattern of business activity.

In forecasting general business conditions, as well as in making individual company forecasts, the role of the economist or market researcher is an important, though limited, one. It is essential, I think, that the forecaster realize that his is not the task of making fundamental policy decisions or political evaluations. Rather, his role is one of pointing out the different implications of various alternative assumptions on various management judgments. In the area of forecasting, this means that he should be prepared to evaluate the results of different sets of assumptions. Though he may, of course, express his own opinion, he should not attempt to usurp the role of management in making the fundamental decisions.

For example, in any forecast of over-all business activity—particularly for the long-run—a number of key political variables must be taken into account: taxes, government expenditures, monetary conditions, and military policy. The forecaster should be prepared to indicate the implications of varying the assumptions with respect to these policies. He must at least indicate clearly, when he makes a specific long-run forecast, what his own assumptions have been; he should also be prepared to describe the modifications required in his forecast should these assumptions be changed. On the other hand, this sort of approach should not be overdone. Little is gained by placing before management some fifty to sixty alternatives. As in all things, there is a golden mean—it is one of the arts of good forecasting to find this mean.

There are two basic kinds of economic forecasting: the long-run view of the nation's economic potential and the short-run cyclical forecast. In both of these areas there have been some recent developments in economic thinking, which may be of value to those who are engaged in the hazardous occupation of forecasting.

### LONG-RUN OUTLOOK

In a long-run forecast we are normally trying to look ahead and see what the productive *potential* of the economy might be in the future. We assume full employment; we do

not attempt the impossible task of trying to guess, for example, whether the economy will be operating in 1970 at full utilization of its capacity. Rather, our major objective is to see what the capacity level of output will be. Short-run forecasting, on the other hand, must concentrate on exactly the opposite problem. Between now and the middle of 1962, the most important variable will not be how much our economic capacity grows, but rather how fully we utilize existing capacity. In a word, long-run forecasting attempts to get at the growth in supply, whereas short-term forecasting concentrates upon fluctuations in demand relative to supply.

*Inputs and Productivity*

An estimate of the potential output of the economy, say ten years ahead, involves essentially two elements: the growth in inputs (chiefly labor and capital) and the growth in productivity (output per unit of input). Some of the most exciting work in economics in recent years involves an attempt to separate the various input and productivity factors responsible for past economic growth. Three names are usually associated with this work: Robert Solow of MIT, John Kendrick of the National Bureau of Economic Research, and Edward Denison of the Committee for Economic Development. While their methods differ and their results are not exactly the same, one essential finding stands out—the overwhelming importance of the growth in productivity as compared to the growth in inputs in explaining the historical growth of per capita income in the United States.

During the past thirty years, the rate of growth in output per man hour has averaged about 2.3 per cent per year. Of this, only about 0.3 to 0.6 per cent can be accounted for by increased inputs of capital per man hour. The rest—1.7 to 2.0 per cent—stems from such factors as the improved *quality* of labor and capital, better technological knowledge, and advances in management techniques. In turn, the improved quality of labor inputs stems primarily from the growth of education, in the sense that the average worker today has had far more schooling than his father who, in turn, had far more schooling than *his* father.

None of this is immediately helpful to the long-term forecaster; however, it does emphasize, on the one hand, the complexity of factors determining our long-term growth rate and, on the other, the difficulty in bringing about substantial changes in that growth rate. For many years, economists have tended to regard the input of capital as the major factor behind per capita income growth. The more recent studies have brought to the foreground the importance of technological progress and education. A striking example of this is found in the postwar experience of such countries as France, Germany, and Italy. The existing capital stock of these nations, particularly Germany, was practically destroyed in World War II; yet in the short space of fifteen years, their over-all output and productivity has soared far beyond prewar levels. If I may oversimplify, it is not really so hard for a nation to provide itself with capital. What is difficult is to provide the necessary skills, the know-how, the technology, and a favorable environment; without these, investment of and by itself, contributes quite modestly to economic growth.

While recent investigations of the facts behind economic growth have indicated the difficulties of speeding up the long-term growth rate, we should not be led into downgrading attempts to achieve such a speed-up. Remember the magic of compound interest; an increase in the annual rate of growth from 3.0 to 3.3 per cent does not sound like much, yet it is a 10 per cent increase. Twenty years from now, this additional "little" 0.3 per cent would mean that the 1980 gross national product (measured in today's prices) would be $60 billion higher than it would be with a 3.0 per cent growth rate. This discussion of the factors responsible for economic growth may not be of immedi-

ate use to the practical forecaster because it does not tell him what the rate of growth will be; nevertheless, a knowledge of these considerations should help to orient his thinking.

*GNP Composition*

The real provision of an over-all gross national product figure, however well-conceived it may be, is only the first step in a long-run forecast. Alone, it has little use. The next step must provide some measure of the potential composition of GNP by major categories. Only after this is done can we begin to relate our long-run economic forecast to the prospects for the individual company.

In forecasting the composition of gross national product, one aspect must not be overlooked; we cannot get around making some estimate of the political climate. Take consumption expenditures, for example. The proportion of total gross national product that will be devoted to consumer expenditures will depend not only on the proportion of disposable income that consumers choose to spend on consumer goods but also on the proportion of total income which goes into disposable income. The consumption rate out of disposable income has tended to remain reasonably constant over the years and, under normal circumstances, presents no problem to the forecaster. The real difficulty lies in estimating what proportion of total gross national income (=GNP) will flow to consumers. There are two magnitudes involved here: first, the proportion of total income that is retained by corporations and, second, the proportion taken by the government in taxes. Even if we assume that the percentage of total income flowing into corporate retained earnings remains unchanged, we cannot assume that the proportion taken by the government is constant. We have a progressive personal tax system; moreover, under present tax laws, the level of exemptions is a fixed dollar amount. For these reasons, the proportion taken by taxes will rise as income grows. In turn, this implies one (or a combination) of four results: government expenditures must rise as a percentage of gross national product, tax rates must be cut, monetary policy must be eased, or if none of the above is done, full employment will become increasingly difficult to attain.

Unless we are willing to assume long-run periods of substantial unemployment, we must make some assumption about a change in government policy—it cannot remain the same. And, of course, the final composition of gross national product in our outlook year—say, 1970—will be quite different depending upon which particular policy change we wish to make. While this does not make the choice between conflicting possibilities easier, it at least puts us on notice that we have to choose.

## SHORT-RUN FORECASTS

Even though it is closer at hand, forecasting the short-run outlook is much more difficult than evaluating the long-term outlook. The main problem is that our mistakes catch up with us so very quickly. I know of no secret formula for avoiding such mistakes—putting one's neck on the block is an inherent occupational hazard. Examining two important factors of the economy—consumption outlays and inventory investment—may help avoid the more egregious errors.

*Stability of Consumption*

One of the striking phenomena of the postwar period has been the fact that consumption outlays have declined very little in each of our recessions. In 1958, for example, GNP fell by $16 billion, but consumption only $1 billion. The reason for this stability of consumption does not lie in the fact that consumers have continued to spend when their income fell; rather, it stems from the notable fact that their incomes fell scarcely at all. Put another way, most of the decline in total gross national income during recessions was absorbed, not by consumers, but by other income recipients. There are three key factors involved in this. *First,* retained corporate

earnings and corporate profits taxes, which together normally account for 11 to 12 per cent of gross national product, absorbed 50 to 60 per cent of the decline in gross national product during postwar recessions, leaving personal incomes to absorb less than half. *Second,* government transfer payments, particularly unemployment compensation, tend to rise during recessions, offsetting a good part of the drop in personal income that does occur. *Third,* the remaining, relatively small decline in personal income is borne partly by the government; if incomes fall, taxes fall, so that consumers' after-tax income declines by less than their before-tax income.

In the postwar recessions, the combined influence of these factors has meant that consumer after-tax income, which normally accounts for 60 to 70 per cent of gross national product, has absorbed only 10 to 20 per cent of the decline in GNP. Small wonder that consumer outlays have been relatively insensitive to recession influences.

Unless we take this into account, economic forecasts based on a typical short-run Keynesian model are likely to overstate the cumulative impact on the economy of initial recession influences. I am well aware of this, having learned the hard way, by ignoring some of the factors just described. It is also important to know that these factors work in reverse. Just as a decline in gross national product tends to have only a modest influence on disposable consumer income, so a recovery in gross national product has a modest influence on consumer income in an upward direction.

### *Inventory Investment*

The most volatile sector of the economy, in moderate recessions at least, is inventory investment. This component of gross national product tends to fall dramatically during a recession and to rise sharply in recovery. The standard technique for evaluating the outlook for inventory investment is to work with inventory-sales ratios. Recent investigations of the influences affecting aggregate inventory investment, however, have discovered the fact (presumably known already by most businessmen) that the major influence on inventories is the relationship between new orders and sales. The rate of change in backlogs, in other words, is the key variable to watch. Any attempt to handle the inventory component by observing inventory-sales ratios alone is certain to understate the fluctuations in inventory investment.[1]

AN EVALUATION of the over-all state of the economy cannot stop with an estimate of short-term movements in gross national product. We must also compare our forecasts of *actual* gross national product with *capacity* or full-employment gross national product. The current recession, for example, will probably be one of the mildest on record in terms of how far we have declined from the previous peak and how long the recession lasted. However, we never fully recovered from the 1958 recession; unemployment in 1959 and 1960 never fell significantly below 5 per cent of the labor force. Conversely, even a fairly rapid recovery during 1961 would leave us well below the economic potential of the nation.

We must be concerned with more than just the stability of gross national product; the level around which it fluctuates is also of crucial importance. To determine the employment implications of our forecast and to evaluate the long-run strength of investment demand, it is important to get some idea of the gap, if any, between our forecasted level of gross national product and its full employment level. To get a "feel" for the health, prosperity, and general buoyancy of business conditions, we must forecast not only where we are going, but where we are going in re-

[1]For those who are interested in following this up, the following references may be useful: J. Duesenberry, O. Eckstein, and G. Fromm, "A Simulation of the United States Economy in Recession," *Econometrica,* XXVIII (Oct., 1960), especially 795-800; P. G. Darling, "Manufacturers' Inventory Investment, 1947-1958," *American Economic Review,* XLIX (Dec., 1959), 950-62.

lation to our potential. A new high in the level of gross national product does not in itself imply a boom economy. If I may use an extreme example, the year 1935 was sharply higher than the year 1931, but no one would characterize the 1935 economy as one of vigorous prosperity!

## GENERAL BUSINESS AND THE SALES FORECAST

JAMES L. RICH

THE TOTAL amount of our gross national product is an interesting background statistic that is sometimes useful in business forecasting. Our economic environment is the "ball park" in which every firm must play, and it is helpful to have a rough over-all idea of the size of that ball park.



However, there is a tendency to overemphasize a total gross national product estimate at the expense of detailing the composition of that figure. This is not to say that the total is not important, but rather, that the composition is of equal, and in many cases, greater importance. As a business firm prepares a short-run forecast, it will undoubtedly find that one or more specific elements of the total economic picture will be of particular interest. A projection, analysis, and understanding of these elements, then, should be an integral part of any projection of gross national product.

In light of this philosophy, it would be helpful to examine the basic structure of our economy. There is, of course, no set pattern of sales forecasting methodology appropriate or advisable for all industries, much less for all firms. However, some general concepts can be considered.

First of all, gross national product can be divided into four major parts—consumer spending, business investment, government spending, and net exports (exports have taken on new importance in the past two or three years). The first part, consumer spending, can be subdivided into durables, nondurables, and services, all key elements in forecasting many end-use products in the market place. Business investment includes spending for producers' durable equipment and all private construction, and is the important element in net inventory change. Government spending can also be broken down into detail. The kind of firm and the purpose of the forecast will determine how many background details are vital to accurate sales forecasting. For example, in 1960, many forecasters made remarkably accurate estimates of total gross national product. However, failure to make a sufficient allowance for inventory change meant that the actual sales results often differed sharply from the sales forecast.

The characteristics of the firm making the forecast determine, to a great extent, which sector is most important. However, it would be safe to say that most firms in most industries would be either directly or indirectly interested in the consumer area. A sales forecast is usually concerned with this area either directly—with a consumer product—or indirectly—with consumer information as a general indicator. A good example is the automobile sector of consumer durables, an excellent weather vane for showing how people feel about the future. If we watch this sector closely, we will find that it usually reflects the general impression that American people have about the economy and their own well-being. Probably no other single product demand expresses these attitudes so adequately.

As we move from the general economy to a particular industry or product, we must sharpen our focus and examine specific sectors in still greater detail. In fact, the bulk of the forecasting effort should be devoted to an industry-by-industry, market-by-market, and product-by-product analysis. To do this adequately and accurately, we must give pertinent sectors an almost microscopic examination. This appraisal must be reviewed and revised almost continually in order to keep up with rapidly changing conditions.

Obviously, the next step is to use the market forecast as a basis for the sales forecast of the individual company. Here the forecaster must incorporate internal data provided by the sales and accounting records of the firm. Such factors as possible changes in sales objectives and the development of new products must also be carefully considered.

All other things being equal, one of the more common techniques for making the individual company sales forecast involves computation of the company's assumed share of the market. With a reasonable market forecast as a starting point, this is a relatively simple, practical, and potentially accurate method. It should be pointed out that the determination of this share of the market will be affected by changing competitive conditions and other random factors. Another useful tool in developing the firm's sales forecast is the analysis of patterns of incoming orders. For many types of industries, the lead time is long enough to utilize such an analysis as an indication of significant new trends.

The preceding discussion has been concerned with the short- rather than long-run sales forecasts. However, no discussion of sales forecasting would be complete without a consideration of long-run forecasting (beyond one year). In long-run forecasting, the firm has more time to take the necessary steps to see that market opportunities are fully utilized. The successful modern business firm will put into effect a number of ideas, programs, or innovations that will lift the firm to its projected level and help it to meet its sales objectives.

Obviously, there are no magic formulas for success. There is, in fact, no significant gap between the so-called forecasting experts and business executives with good common sense. However, when a forecaster can combine some of the statistical techniques available with common sense, the chances of a more accurate, more usable forecast are improved.

## SALES FORECASTING IN SPECIFIC BUSINESS SITUATIONS

ROBERT S. ECKLEY

Before proceeding to the subject of the use and application of sales forecasts in business, I should like to supplement the previous discussion of sales forecasting with some comments on two topics. First, it may be helpful to summarize the general steps involved in the preparation of a sales forecast in any practical situation. And, second, since this is an international conference, some discussion of foreign sales forecasting may be of particular relevance and interest. Last year, almost half of the sales of Caterpillar Tractor Co. were made abroad; consequently, we have devoted considerable attention to this side of sales forecasting.



### FORECASTING STEPS

Sales forecasting, based on information about the state of the economy, involves five basic steps, and it may be helpful to recognize them as logically separate decisions. (Other forecasting methods, based on field surveys or the direct manipulation of internal company data, may proceed in somewhat different fashion.)

1 A forecast of various economic aggregative measures is made either by the sales forecaster himself or by some outside agency. These measures may be the index of industrial production, various GNP components, or other economic variables of particular significance to the industry under consideration. For example, in the construction machinery industry, we are interested in changes in construction activity.

2 A relationship between industry sales and one economic measure or more, obtained through regression analysis, may provide a reasonable expectation as to industry sales during the forecast period. The value of a statistical forecasting equation derives from the fact that it forces one to be systematic

and precise in the logical relationships utilized; its disadvantage lies in the fact that it is often impossible to reduce to a few simple statistical relationships all of the determining factors operating in a given industry.

3 A forecast of company sales requires that the industry forecast be reduced to the company level by anticipating the market share that the company may expect to obtain.

4 Sales of many types of products are subject to seasonal variation, and the anticipated seasonal pattern must be applied to obtain the actual sales expected quarter by quarter or month by month. Computer techniques (the Shiskin method is perhaps the best known) have revolutionized the calculation of seasonal indexes, making rapid and improved seasonal indexes readily obtainable.

5 Industry sales forecasts usually involve broad product classes, which must be broken down or reduced to a product mix that has meaning for the management of a company. Product mix expectations are pseudoscientific at best and obviously involve the anticipation of changes in taste, the effect of engineering changes, and so on.



## FOREIGN SALES FORECASTING

Foreign sales forecasting presents some unique and rather difficult problems, often complicated by the paucity of information. The degree of geographical detail required is usually determined by the number and location of sources of supply—whether or not a given foreign market will be supplied from domestic plants in that country or by imports from outside. Lessons learned through market research in the United States are usually applicable to the industrial countries. In the case of the primary commodity exporting countries, the approach to sales forecasting must be substantially modified. Their ability to import goods from the industrial countries is usually dependent on their foreign exchange earnings.

Canada most closely resembles the United States in the type of economic information available, in social structure, and in the fact that it is closely related to the U.S. economy. From the standpoint of statistical information, the OEEC countries are relatively well covered, although considerable diversity exists in the compilation of detailed information in their different governmental organizations. Moreover, Western Europe has displayed a marked degree of independence from U.S. business fluctuations during the postwar period. Thus, it is necessary to make an independent analysis of economic conditions in Western Europe in order to arrive at a proper appraisal of probable economic change. Japan constitutes another relatively unique case.

For the bulk of Latin America, Africa, South and Southeast Asia, Australia, and New Zealand, a forecast of purchases of goods from the industrial countries must start with a forecast of export earnings. This may be approached individually or collectively for groups of these primary commodity exporting countries. The job of forecasting export earnings seems excessively complex at first glance, but investigation reveals that exports of about eight commodities provide more than half the earnings from total commodity exports. Therefore, an analysis of a limited number of international commodity markets—oil, coffee, cotton, wool, wheat, cocoa, copper, and rubber—provides a substantial start in analyzing fluctuations in earnings of the primary producing countries. Obviously, price fluctuations in these commodity markets can be related to economic conditions in the industrial countries and supply conditions for the commodities involved. The existence of foreign exchange reserves provides a cushioning effect for changes in export earnings and imparts a lagged effect between increases or decreases in export earnings and their impact on foreign trade. In any individual country, of course, the political situation and loans from foreign sources may significantly color the market outlook.

### USE OF FORECASTS

The use of sales forecasts in any company tends to be an organizational art—a tribal rite. Hence, a discussion of current practice is probably more informative if it does not make dogmatic assertions about the propriety or superiority of any particular arrangement. Within the business organization, the person responsible for sales forecasting is generally found to report to (1) the chief executive officer or an executive committee, (2) the finance officer, or (3) the sales executive. The arrangement chosen determines to some extent the orientation and coloration of the forecasting effort. However, perhaps a more important determinant of the success of the sales forecasting effort is the stature attained by the forecaster within the organization, wherever he is located.

The period to be covered by a sales forecast and the frequency with which forecasts are issued should obviously be determined by the purpose to be served. Perhaps the chief uses of sales forecasts are in production scheduling, budget preparation, cash flow analysis, the evaluation of sales effort, and the determination of plant capacity requirements. With the exception of the last-named use, a forecast period of one year or less is generally satisfactory. For longer-range corporate planning purposes, such as the anticipation of plant requirements, longer-range projections are necessary. The focal point of interest in the short-range forecasts centers on cyclical changes in economic activities in contrast to longer-range projections that direct attention to the growth of maximum demand; consequently, entirely different technical problems are posed for the economist or market researcher working on forecasts covering these two different time periods.

The presentation of sales forecasts should be properly viewed as a continuous process. It is a part of the task of disseminating—throughout the organization—external information affecting its operations. Successful efforts involve the use of all types of communicative techniques — oral, written, and graphic. Different types of presentation designed to serve various purposes in the dissemination of sales forecast information are illustrated by the following four examples: (1) quantitative forecasts that are specific and detailed are required for production scheduling purposes; (2) an oral discussion of the economic background information and a summary of the forecast data may be sufficient to keep general management informed periodically; (3) a quarterly statement or letter on general economic and market conditions of particular significance to the company may serve as a means of communicating to a management that is scattered geographically; and (4) informal discussion, letters to division heads or subsidiaries, and other informal methods should not be overlooked as effective devices for continually updating sales forecast information.

An essential part of any sales forecasting procedure is the provision for regular review and evaluation. This may take the form of comparison with historical data, but also should involve a routine comparison with current order information, field sales, and current forecasts from sales personnel. It should be emphasized that the need for accuracy is a relative one. A 2 per cent tolerance for errors in annual forecasts of the index of industrial production may be entirely reasonable. Such a margin for gross national product forecasts, a more stable variable, would be unacceptable. Similarly, sales forecasts for the oil or soft goods industries should involve a narrow margin of expected error, whereas a wider tolerance is appropriate in the volatile machinery industries.



## DISCUSSION HIGHLIGHTS

JACK R. WENTWORTH

THE PRINTED page cannot reflect the comments, brisk debates, and thought-provoking questions of the discussion period. Yet, an attempt will be made to summarize two or

three of the more perceptive points of discussion.

John P. Lewis, at one stage in the discussion, emphasized that the value of the GNP model as a fundamental element of the sales forecast cannot be overstated. It keeps the forecaster from overlooking the "bugs" that can often creep into the forecast, and permits a quantification that keeps the various magnitudes in their proper perspective. This quantification is needed; after all, we cannot add up adjectives. Lewis also pointed out that the GNP models discussed were based on the expenditure side of our national income accounting system. The forecaster may want to look at the receipt or income side of the ledger, both for purposes of comparison and for the valuable information that it contains in its own right.

The discussion on forecasting the firm's market share after the industry share has been determined proved to be one of the highlights of the session. The point was made that it is not fashionable to forecast anything but an increase in market share. The obvious response to this was that, if every firm forecasted an increase in market share, surely we would end up with 120 per cent of the industry. As was pointed out, this can happen and has happened as the natural result of an overstated forecast. However, one must also consider the effect of introducing new products. These may help to create a larger market than was originally anticipated.

The longest and liveliest discussion centered on the concept of what to do when the sales forecast is obviously off course. How do we adjust the forecast when this happens?

A number of companies automatically compare actual sales and forecasted sales in their quarterly budget re-evaluation. But the degree of flexibility, of course, depends upon the type of firm. The major problem seems to be coordinating production to sales. If actual sales are greater than forecasted sales, the production problem can be handled to some extent by overtime. It is possible to build some flexibility into the forecast through the use of ranges, alternative forecasts, and alternative budgets. However, most firms would find that, since many important business decisions have to be made on the basis of the forecast, the flexibility of the plan would eventually have to be replaced by a specific, definite sales forecast.

Finally, the important point was raised that there must be two-way communication between sales forecasting and the rest of the marketing organization. The forecaster must take into account the many other marketing elements that help establish exactly what the firm can market for a given period. The sales forecast and the over-all marketing strategy are dependent one upon the other. The sales forecast is a vital factor in determining the marketing strategy, and in turn, the marketing strategy helps to determine the sales forecast.

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# MARKET MEASUREMENTS

## INTRODUCTION

Ronald P. Willett

It is stating the obvious to say that contemporary marketing activity has as its primary focus some orderly classification and satisfaction of existing or latent demand. Marketing management, unlike traditional sales management, implies laying the foundations for successful market penetration substantially in advance of applying selling and other promotional effort.

Nevertheless, a sizable number of management failures in developing, carrying out, or controlling total operating strategies probably have their cause in unsatisfactory identification, classification, or measurement of the existing or potential market. Even when the market has been carefully defined and measured through research, inadequate or improper translation and communication of findings to decision-makers may also contribute to the failure of the firm's marketing program. Quantitative market measurement and integration of market measurements with other planning and control devices have been less than sophisticated attributes to the implementation of demand orientation. Nor have firms solved the strategic problem of selecting among utilities and their associated market structures.

Any satisfactory recodification of market measurement concepts and techniques will have to reflect a number of basic changes. First, the very meaning of a market and a market system might well be reconsidered so that we gain a better understanding of market variables and their interaction. Second, the scope and substantive content of classes of market measurements should be given critical scrutiny. Third, we should appraise the logic and mechanics of quantitative techniques currently used and the wealth of new quantitative techniques that are potentially applicable. Fourth, and perhaps most important, the process for making

market measurements an operational part of the firm's decision-making system should be clearly defined.

In the following papers, an attempt is made to touch on some of the issues outlined above. Perhaps the ideas presented will provoke more thorough investigations of, refinements in, and applications for the various classes of market measurements.

## MARKET MEASUREMENTS AND THE ADMINISTRATIVE PROCESS

Harper W. Boyd, Jr.
and Richard C. Christian

Market measurement is a complex subject because it includes such a great diversity of research studies. This complexity and diversity are a result of the many different kinds of markets that exist—both industrial and consumer—and the many dimensions to any one market that need to be studied if a firm is to be successful. Thus, market measurements include studies that measure or specify the size of the market for a specific product or a group of related products, the market share for a particular brand, the profile of the buyers of a given product and/or brand, consumer attitudes, the demand for a new product, and consumer acceptance of it. Any one of these areas would require considerable discussion if all of its aspects, including research methodology, were to be considered in detail.



All market measurements have a common purpose: to help the executive staff of a company minimize the risks inherent in making decisions. Moreover, the use of market measurements will perhaps be more meaningful if their importance in the total operation of the firm is stressed. It is, therefore, the purpose of this paper to discuss market measurements as an integral part of the administrative process.

The administrative process consists of setting objectives, formulating plans, organizing, and controlling. While this is not a new concept, it does provide the executive with a useful frame of reference. It enables him to perceive the totality of the firm and to relate its various functional activities to a central theme. Using this process, he can make a more realistic diagnosis of day to day problems, and he can better distinguish between symptoms and basic problems. It represents a sequence of steps, all interlocking.

It is essential to note that this process requires a continuous flow of information about the market place as well as an appraisal of the firm's efforts to exploit the market. Without such information, the chief executive officer has to make his decisions in a vacuum. If this officer takes full advantage of the administrative process concept, he will be able to anticipate the kinds of information that he needs concerning the market. Market measurements—in the sense we are using the term—are essential in all the steps of the administrative process.

### SETTING OBJECTIVES

The broad objectives of the firm include making a profit as well as carrying out certain stated or implied obligations to stockholders, the community, and labor. These objectives are, of course, very important, but they do little to provide the firm with a precise rationale for its existence. Some individuals like to think of a firm's objectives in terms of its products or services. While this concept is helpful, it still does not deal with the specific uses to which the products and/or services are put. Since use should predetermine the specific character of the product, it offers a more definitive statement of the basic objective of the firm.

Another way of stating the basic objective is to discuss it in terms of the "market niche," that part of the market which the firm will attempt to capture by offering certain products or services. Implicit in this concept of the market niche are the realizations that different segments of the market have different needs and that a firm will attempt to develop or tailor a product or service to meet the needs of one or more segments. Often, market segments will have conflicting needs and, obviously, the greater the conflict the more important it is for a

firm to specify exactly what segment it is attempting to serve. This is not to say that a firm should not attempt to serve more than one segment at any one time. Many firms do this quite successfully by offering a number of different products. The Ford Company, for example, offers the Thunderbird, Ford, Lincoln, and Falcon cars; General Motors appeals to different market segments with its Cadillac, Buick, Pontiac, Chevrolet, and Corvair.

*Broad Market View*

A firm should view the market need in the broadest possible light. It should think first of the generic need and then deal with the niche or segment concept. For example, assume we have the problem of setting objectives for a domestic watch producer. Rather than think of the firm's objectives as producing a line of watches, we could and should think first of the generic need we are attempting to satisfy. This generic need is the need to measure time. Note that we did not specify this need with reference to any group or groups of people.

The need to measure time requires further elaboration; this will point up the presence of a number of different segments, each having a different set of needs. For example, we can break down our generic need by considering the circumstances under which the need manifests itself. There is a need to measure time in such circumstances as travel and work. Each of these can in turn be subdivided; travel can be broken down into business travel, travel with one's family on a camping trip, travel abroad, and so on.

Another set of circumstances in which the need to measure time is important pertains to starting or completing a given task. These circumstances may require the activation of another mechanism such as an alarm—or a triggering device like a timer that regulates the cycle on an automatic washing machine.

If the above example were carried far enough, a great variety of market segments could be identified. Certainly the watch manufacturer could conceptually view the total use function as offering the possibility of producing a variety of clocks, watches, and timing mechanisms. At this point, he would realize that he probably could not satisfy the needs of all these different segments; his resources simply would not permit him to do so. But before deciding what segment(s) to take on, he should measure the relative importance of each, the requirements of each, and the strength of the firms currently serving these segments. These measurements can then be used to assess the firm's resources, and the assessment, in turn, enables a decision to be made as to which segment(s) will constitute the firm's market niche.

Assume that our watch manufacturer has listed the various segments whose needs he feels can be met through the production of mechanical clocks. One of these segments, according to his analysis, calls for the possible production of a travel alarm. Assume that an investigation reveals that about one million of these are sold annually and, further, that a partial listing of the needs of this segment calls for a product that is reliable, compact and easy to carry, durable and shock-resistant, easy to operate, and reasonably inexpensive since it is used infrequently. Given such information (in considerably more detail, of course), management can determine whether the resources of the firm in comparison with those of the firms now selling to this market segment are adequate in both the short and the long run.

*Measuring the Market*

The firm must have a precise way of measuring the size and characteristics of the market segment before deciding whether to attempt to sell to it. It is also imperative that management continue at regular intervals to measure this market segment and, in particular, those forces that may work to change its importance and character. Basic trends (such as the changing age distribution, increase in travel abroad, use of certain power units such as batteries, and rising per capita income) may accelerate innovation from

present competitors with a subsequent loss in market share on the part of our seller.

The firm's annual sales forecast is one of the most important types of market measurement. The firm must then proceed to break down this over-all sales volume estimate by geographical administrative units. It is easy to imagine a situation where the over-all sales forecast would remain essentially the same, but the sales in certain geographical areas would change substantially. While such a shift would not be likely to produce a change in the firm's objectives, it would probably have a pronounced impact on the firm's selling strategies.

In summary, it is not difficult to identify the many ways in which market measurements are indispensable in the determination of the firm's marketing niche. Without such measurements it would not be possible first, to determine what criteria might prove useful in segmenting the market; second, to determine the relative worth or value of the various segments; third, to obtain information about the needs of the segments; fourth, to measure the actions of present and potential rivals in attempting to sell to the segments; fifth, to assess the firm's ability to sell to the segments; sixth, to forecast what industry sales will be for some stated time period; seventh, to estimate the firm's market share, thereby providing a sales forecast for the firm; and eighth, to break down the firm's forecast geographically so that sales goals may be set up for its administrative units.

### PLANNING STRATEGIES

The planning function must obviously be related to the firm's marketing niche. The purpose of planning at the top management level is to develop a set of strategies that will profitably exploit the market niche. The plan must take into account the characteristics of the market, the resources of the firm, and the economic environment. In fact, one way of testing the feasibility of a given niche is to develop and cost out a given plan.

Any plan has to make use of various strategies. Generally speaking, there are five major strategies: product and product line, channels of distribution, advertising, personal selling, and price. Each of these strategies represents a very broad area. In product and product line strategy, for example, there are countless ways of producing a product to meet a given set of needs. There are many ranges of quality, of construction materials, of colors, shapes, and styles from which to choose, and countless ways of putting these factors together. A multiplicity of copy themes and media choices are available for advertising a product. Moreover, all strategies are interdependent. Product quality will obviously affect price and margins, which in turn will affect channel selection, advertising, and the extent and scope of the activities of the sales force.

None of the strategies mentioned above, let alone their optimum combination, can be planned or implemented without reference to the worth of individual geographical units. Unless one knew the relative importance of, say, California versus Florida, one could not determine how to allocate the marketing dollar. Of course, one might decide to build from the individual geographical unit up to the total forecast; even so, the importance of the unit estimate remains much the same. How else can one decide the number of salesmen to be located at certain places or the way they should be routed? How else can one decide how much advertising should be placed in a given market? And how else could one decide the number of retailers or wholesalers to use in various locations?

### ORGANIZING

The firm develops—or should develop—an organization structure adequate to carry out its plan. Here we are concerned not only with the number and caliber of people, but also the way in which they are assigned responsibilities and communicate with one another. The organizational system must be extremely sensitive to the strategies used by the

firm in selling to the given market niche. It must respond to changes in the niche and must be able to communicate these changes through the organizational levels without distortion. It must also filter out the unimportant bits of information so as not to inundate management.

In certain situations the company has no alternative but to use its salesmen to relay back the changes at the customer level. This is particularly true of a firm selling a technical product such as original equipment. In other circumstances, the firm may choose to circumvent its own sales organization by using a marketing research unit to contact and report back on the goings on in the market place. For example, firms selling highly volatile consumer products, such as personal care items, typically use marketing research units to measure the firm's performance.

The organizational system within the marketing department must provide for the proper relationship between line-and-staff personnel, a precise specification of each individual's job, and an authority system that will control the organization over a period of time. Concepts of centralization versus decentralization are also important.

All dimensions of the organization system (formal structure, communications, authority, control, and so on) are interrelated and changes in any one will inevitably affect the others. No one area of decision-making is as difficult to contend with as that which concerns the organizational system. It is easily the most sensitive to any failure on the part of management to recognize changes in the external environment as well as changes that need to be made within the firm to accommodate shifts in the market place. Certainly then, the organization should be structured and maintained on the basis of market measurements not only because of the role such measurements played in determining the niche and specifying the optimum marketing mix of strategies, but because market measurements themselves are a continuous activity of the firm and must be accommodated in the organization structure.

## CONTROLLING

The control function consists of following up to determine whether a job is actually being done in the way(s) prescribed. There is always the probability that events will necessitate certain changes in the plan or the organization or both. Also, there is always the need for management to be aware of market place activities—both long-range trends and changes in the strategies employed by competitors to exploit the market. In another of its aspects, control deals with mistakes in that it attempts to identify them, rectify them, and prevent them from recurring.

Standards are an essential part of the control operation since actual performance cannot be appraised unless it is measured against a set of definable criteria. To be sure, precise measurement of the performance of certain parts of the marketing department (for example, the advertising function) is not always possible. But every effort should be made to establish standards that will facilitate the control function.

Certain kinds of reports are an essential part of the control system. Reports dealing with actual sales versus quotas, brand share within individual markets, brand preferences, attitudes of channels toward the company and its personnel, and certain cost ratios (for example, those having to do with the physical handling of goods) are particularly important to marketing management. In most companies, the marketing research unit spends a large part of its time and budget obtaining, analyzing, and even interpreting control information.

Inevitably, control leads to reappraisal. If it did not, then control would be a static process applying solely to the present state of events and would not lead to changes in any of the major steps in the administrative process. Yet the market-oriented firm is by definition flexible and dynamic, responding in a positive way to changes in the market place. Reappraisal must be a continuous process whereby management con-

stantly assesses its commitments of the firm's resources to a given set of strategies designed to exploit a given, definable market niche. And thus the administrative process is a continuous circle: objectives are changed; these changes, in turn, produce a need for a change in the firm's strategies; and this in its turn presents a need for a change in the organizational system.

## Case Study

IN LATE 1958, the Farm Tractor Sales Department of a large farm equipment manufacturer faced the problem of establishing reasonable sales goals for industrial wheeled tractors for each of its fifty sales districts. The problem was not new, but was becoming more important each year because of the expanding number of industrial tractor sales as a percentage of the total domestic tractors sold. The figures are shown in Table 1.

TABLE 1

**Domestic Tractor Shipments for Farm and Nonfarm Use, 1955-57 (in thousands)**

| Year | Total* | Farm | Nonfarm | Percentage Nonfarm |
|---|---|---|---|---|
| 1955 | 286 | 263 | 23 | 6.9 |
| 1956 | 191 | 170 | 21 | 11.0 |
| 1957 | 204 | 179 | 25 | 12.6 |

*Total does not include contractors' "off highway," garden, and crawler-type tractors.

SOURCE: Department of Commerce, *Facts for Industry*, 1955, 1956, and 1957.

Statistics on tractors sold for nonfarm use were not available before 1955. The company had, for many years, been able to work out sales goals at the county level for its farm tractor sales. The procedure was simple and was based on the Census of Agriculture, which gave the number of farm tractors in each county. The company, however, was "guessing," as late as 1958, at the number of industrial tractors it should sell in each sales district. The manager of the farm tractor sales department did not know whether, on the basis of potential customers, a district that sold 50 tractors per year was doing as well as a district that sold only 25.

In 1955, the sales department had instructed its district offices to obtain a detailed dealer report on the sale of each tractor for other than farm use. This reporting was continued for 1956 and 1957, but the dealers had difficulty determining which of their tractor sales were for industrial use and which for farm use. The sales department analyzed in some detail the report forms for the period November 1, 1955-June 30, 1956. It noted that the company's share of the industrial tractor market was lower than that of the farm tractor market.

In the spring of 1958, a study was made of the sales of industrial tractors for a six-month period. Contractors, political subdivisions, and service and maintenance users appeared to make up the biggest market for tractors for industrial use. Contractors of all types were important. Political subdivisions and institutions such as schools and hospitals used tractors in grading, excavating, landscaping, and mowing. Service and maintenance users such as dealer rentals, florists, estates and private homes, cemeteries, motels, and resorts used tractors for grading, mowing, landscaping, hauling, excavating, and loading. The small tractor, priced at about $1,200, and the middle-price tractor, selling for about $2,500, accounted for about 90 per cent of the sales for industrial use. The company distributed its tractors through more than 1,000 farm equipment dealers who handled only farm equipment, and some 3,000 dealers who sold both farm equipment and trucks.

In studying the survey data, the firm's research department noted that the sales of industrial tractors were related to the size of the population, the rate of growth of an area, the type of industrial activity in the district, and the density of estate-type homes. In attempting to find a solution to the problem of setting district sales goals, the research department ranked all states according to the company's 1958 industrial tractor sales (based on six-month data only)

and compared this with rankings based on population and rate of growth of households. Some correlation existed among these three measures, although in certain cases the relationship was a remote one.

### A NEW MARKET NICHE?

The problem stated at the outset of this case study—that is, the determination of sales goals by districts for tractors for industrial use—begs the basic question: "Is a new market of sufficient value available to the company?" To answer such a question, the firm will have to forecast the use of such units over a reasonably long period of time—say, five to ten years under varying assumptions.[1]

Examples of such assumptions would be: (1) that present models and attachments are sold to this new market or that different and new products are designed especially to meet the needs of the niche; and (2) that present marketing strategies are used or that new strategies, such as different channels of distribution, are employed.

But to achieve a reliable forecast, this company must first identify the various market segments and then place a value on the needs of these segments relative to their being solved by the firm investing in a given type of tractor with certain attachments. Once an industry forecast is made—and the firm may wish to set up a minimum and a maximum forecast—then the company must estimate its share at the district level, although doing this requires a decision on what strategies the firm will employ. Thus, its share might be estimated as one figure using present channels and another figure using new channels.[2]

[1]Actually, the number of possible assumptions is infinite since there are countless ways of structuring a "new" product and combining it with a variety of strategy mixes.

[2]Here again we note the interaction between the action taken by the firm and its share of the market. Forecasts should "become action guides by showing the probable results of the various plans and policies that management may adopt to exploit (or fight back) those externally imposed economic conditions and to select the course of action which will maximize earnings in the light of changed outside conditions." See Joel Dean, *Managerial Economics* (Englewood Cliffs: Prentice-Hall, Inc., 1957), p. 143.

The company does possess some useful information on the sales of tractors for industrial use. Probably the most important is information identifying the kinds of buyers. We know that there are a number of different buyers including contractors, owners of estate-type homes, institutions, and political subdivisions. We also know that such buyers concentrate their purchases on two models. What we do not know is precisely how they use the product and, perhaps even more important, what their needs are. We cannot determine, therefore, how satisfied they are with available tractor models. We also know that the existing market for tractors used for industrial purposes is somewhere between $40 and $60 million (determined by multiplying total U.S. sales of such tractors by the company's average price of tractors sold for this purpose). Certainly, at the present time, this is a small market compared to that for tractors used on farms.



It seems clear that the company does not have the information here to make even a fair forecast of the sales to such segments. Further, it is doubtful if it can use secondary data for such a purpose. The alternative is, of course, to go to the users and obtain the desired information. This would require the following steps:

1 Identify users of the product. This would not be difficult since the firm has a list of buyers that goes back some three years. In addition, a list should be made of firms, institutions, and so forth that to the company's knowledge have not purchased a tractor. The effort here is directed toward getting a list of firms who are not users.

2 From the above list, select a representative sample of buyers to interview. Probably, the list should be first stratified by type of user—contractor, political subdivision, and so forth.

3 Interview the sample units to determine their needs, how these needs are being satisfied, why they have not purchased a farm tractor, and under what conditions they would buy a tractor. All of these are difficult questions to ask—and the answers are difficult to evaluate.

4 Assuming we have used buyer or potential buyer classifications that match the census we can then project our findings to a national level —and, later, can break it down to a county

level. For example, if we find that one out of every two hospitals with 50-75 beds has a need for an industrial tractor, we can project the national need by means of the total number of such hospitals.

The procedure outlined above is greatly oversimplified. There is no indication of its complexity or its cost. The interpretation of the demand for present and potential tractor models would pose some very real problems. And yet the company must attempt a forecast of this kind if it believes that this market has any potential. Not only will such a study help forecast the demand, but it should also provide an excellent guide for the firm in specifying the marketing plan required to tap the various segments. In addition, the study will provide invaluable data, which will help decide what kind of an organization is needed; such questions as those having to do with research and development, the nature of the personal selling activity, and the communications system will at least be partly answered. In fact, this may be the study's greatest value since the firm can, with answers to these questions, determine whether the market potential is worth the candle.



## DISTRICT GOALS

The problem as seen by the firm is partly answered in that the survey could be used to redistribute the forecast for the sale of farm tractors for industrial use to the individual districts. Admittedly, this assumes that the definition and characteristics of the sampling units correspond to those used by the census, which reported the number of tractors by counties. In view of the lack of information, a survey based on this assumption may be the only realistic approach. It is unlikely that the firm's research department will find a single factor index or be able to construct a multiple factor index that will with any degree of accuracy redistribute the national estimate to the district level.

If the firm is able to establish realistic sales goals for each of its administrative units, then it will be in a reasonable position to decide how much sales activity is desirable in each. For example, the number of salesmen can be determined by considering what each must do on a sales call, the number of outlets, the distance between outlets, the paper work involved, and the frequency of call. Most of these factors cannot be determined unless the firm has a considerable amount of information about the market, and so once again we note the importance of market measurements.

Possibly the firm will decide not to strive for a new niche, but will prefer to stay with its present set of objectives and make only slight modifications in its strategies. In such a case, it will, of course, still have the problem of deciding what the sales goals by geographical units should be for the sale of farm tractors for industrial use. Here again there is no easy solution, but an approach along the lines outlined above may be of some help.

IT IS CLEAR that market measurements play a vital role in the administration of the firm. These measurements are essential for those decisions that must be made within the marketing department and also for those that have to be made by the chief operating executive. In fact, the results of the market measurement determine to no small extent the entire business life of the firm. The extent to which the firm is successful depends, to no small degree, on its ability to determine what market measurements to employ, the reliability of such measurements, and the way in which they are interpreted.

An elaboration of the administrative process shows clearly how each step is conditioned by market measurements. Once the firm's marketing niche is specified, the ingredients of the other steps are predetermined. So, no matter whether market measurements are made for a specific step other than the setting of objectives, their impact is an important one.

Too frequently a firm does not have a plan for collecting market measurement data on a systematic basis. But if the needs of each

administrative step are fully understood, top management will set up a specific plan that calls for certain market measurement data at certain times. The plan should indicate the general level of accuracy required and must allot responsibility for collecting and analyzing the data. Further, the plan should provide for a review of the plan itself since over a period of time the need for certain measurements will change.

## HOW AUTOMOBILE COMPANIES MEASURE CUSTOMER SATISFACTION

ROBERT J. EGGERT

AUTOMOTIVE manufacturers — like manufacturers in many other industries—are expanding the use of marketing research as a tool in anticipating and measuring customer satisfaction with their product. Because of the newness of the field, it seems desirable to describe the function in broad terms before getting into the specifics of how we measure customer satisfaction.

### MARKETING RESEARCH

Marketing research began thousands of years ago when man first started to trade; the cave man who wanted to swap his extra pottery bowl for a hunting ax was doing a crude form of market research when he inquired around to find out who needed a bowl. And I have an idea that the beginnings of modern marketing research were almost as simple. But over the years, as our society and our economy became more complex, the need for new techniques arose.

Until recent years, a manufacturer launching a new product was faced with a trial-and-error proposition. He could only guess at the probable degree of public acceptance, and the only way to test demand for a product was to tool up, make it, and put it on the market. The product either sold or it did not. It was a risky and an expensive way to operate.

Though the market place still provides the ultimate test of public acceptance for any product, market research can reduce the risks. It is now possible to get a very good idea of the breadth and depth of a potential market, to locate customers for a specific product, to determine how they can best be told about it, and finally to find out how satisfied they are with it.

Marketing research is not an exact science in the same sense as mathematics or chemistry; it is perhaps more nearly analogous to weather forecasting. The meteorologist measures the direction and magnitude of atmospheric forces in order to forecast weather for a specific area; the market researcher gauges the forces that motivate man to want and to acquire in order to assess probable demand for a product. Forecasters in both fields are confronted by an almost infinite number of variables. For the market analyst, the most elusive variable is man's free will—his ability and his tendency to change his mind. The key to successful marketing research lies in spotting such changes in advance and in determining their extent.

Obviously, it is a practical impossibility to measure and relate all of the forces that bear on any one man's decision-making process. The task would be immeasurably more difficult if one tried to assign values to all of these forces for all men. The practical approach, therefore, is to try to determine from a sample of the population which influences weigh most heavily in forming preferences and which are controlling factors in determining customer satisfaction in the majority of cases. On the basis of this representative segment of the population, the marketing researcher tries to apply the scientific method to the solution of marketing problems.

The function of the marketing researcher in industry is to learn as much as possible about customer preferences, and then to serve as the typical customer's representative in the deliberations of management. His role is to interpret the customer to management, to provide factual information that reduces the necessity to rely on past obser-

vations or on conjecture. In essence, his job is to minimize the uncertainty in management decisions.

### THE AUTO INDUSTRY

As you probably know, the automobile industry is a high investment, high risk enterprise in which irreversible decisions and commitments must be made far in advance of production. Our fortunes ride on the decisions made two to three years before the day we introduce a new model. Management must plan for that new model so that it can be produced on schedule, so that some 10,000 dealers can sell it successfully to some 2 million persons, and so it will return profit on the assets employed in the business. To get a successful reception in the market place, the product must be fully competitive in styling, performance, safety, economy of operation, workmanship, and price.

The task of the marketing researcher begins with the earliest stages of new model planning, continues until the new automobile is delivered into the customer's hands, and ends by measuring the degree of satisfaction with the product after it has been on the market for a period of time. The information he gathers helps to form the basis for management decisions in such areas as volume planning, product planning, and communication with customers.

*Volume Planning*

To help in answering volume questions, the market analyst makes both long-range and short-range market forecasts. The long-range forecast is made at the beginning of product planning and is used in establishing planning volume. For this forecast, the market analyst surveys such indicators as trends in the general economy, in population, in family formation, and the age of cars on the road. Later, after new model production begins, the analyst makes short-range studies that act as a check on the validity of his original long-range forecast. These short-range studies chart actual sales performance of the new model and pinpoint any degree of variation between actual and anticipated sales. This information enables management to tailor production schedules to the demands of the market place.

*Product Planning*

With planning volume established, the market analyst is ready to move into the area of product planning. Volume and product planning are interrelated because volume depends to a large extent upon the competitive position of the product in the market. At this point, the factors of product acceptance and customer preferences enter the picture; the closer a company can come to matching its product to the customer's wants, the greater the share of the total market it can expect to capture.

*Customer Preferences*

A part of the marketing researcher's responsibility is to learn all he can about trends in customer product preferences. For instance, he should be able to advise management on the size of car most customers want, on current likes and dislikes in styling, on customer preferences as to performance, mechanical features, colors, fabrics, and accessories. If the analyst has been asking the right questions of the right people, he can supply management with reasonably accurate answers about the trends in most of these areas. Table 1 shows how customers' ratings of features of their new car may be listed.

In attempting to assess trends in product preference, the analyst sometimes treads on rather tricky ground. He begins by translating broad product problems into specific questions, and then turns to customers themselves for the answers. Clearly, he must exercise great care in setting up the questions; customers can supply accurate answers to some questions about their automobile preferences, but they either cannot or will not supply reliable answers to others. For instance, if we ask our customers what

TABLE 1

**1960 Ford and Chevrolet Buyers Rate Their New Cars**

| Feature | Percentage Rating Feature "Excellent": Ford | Chevrolet | Ford + or — Chevrolet |
|---|---|---|---|
| Ease of getting in and out of driver's seat | 46 | 30 | +16 |
| Windshield | 65 | 55 | +10 |
| Material, design, and color of seat fabric | 66 | 59 | + 7 |
| Rear end | 60 | 54 | + 6 |
| Width of front seat | 68 | 62 | + 6 |
| Width of back seat | 51 | 45 | + 6 |
| Ease of getting in and out of back seat | 31 | 25 | + 6 |
| Hood opening | 52 | 47 | + 5 |
| Side view | 62 | 58 | + 4 |
| Rear fenders | 54 | 50 | + 4 |
| Back seat leg room | 39 | 35 | + 4 |
| Back seat head room | 42 | 38 | + 4 |
| Headlights | 55 | 52 | + 3 |
| Over-all appearance | 64 | 62 | + 2 |
| Dashboard | 61 | 59 | + 2 |
| Tail lights | 52 | 51 | + 1 |
| Over-all interior | 67 | 66 | + 1 |
| Operating economy | 32 | 31 | + 1 |
| Engine power | 56 | 55 | + 1 |
| Front seat head room | 50 | 49 | + 1 |
| Acceleration | 55 | 55 | 0 |
| Front end | 51 | 51 | 0 |
| Front seat leg room | 58 | 59 | — 1 |
| Ease of handling | 69 | 71 | — 2 |
| Operation of brakes | 60 | 63 | — 3 |
| Smoothness of transmission | 54 | 58 | — 4 |
| Riding comfort | 66 | 70 | — 4 |
| Size of luggage space | 55 | 73 | —18 |
| | 18 | 43 | —25 |

SOURCE: Marketing Research Department, Ford Motor Co.

style of automobile they want in 1964, they simply are not able to tell us. The development of styling is a job for experts and is beyond the competence of the average customer. The average customer is, however, able to indicate his current preference among several styles if we show him examples. The tough problem is to interpret his answer—especially in light of how his views might change by the mid-60's.

It is easy to get the customer to talk about what he likes or dislikes in automobiles; but in some areas he is likely to fib a little. Consequently, we have to be careful how we ask our questions. If we ask customers point blank, "Do you want more trim on your car?" almost all will say "No," and then many, even in today's more conservative market, will go out and buy a car with a great deal of chrome on it. But by careful phrasing of questions and by careful selection of the customer sample, it is possible to learn enough about trends in customer preferences to minimize costly product mistakes.

With volume established and key product design questions resolved, the new automobile moves on through supply and tooling phases to the point where it is ready for production. By this time, it has long since passed the point of no return. The styling and engineering and all the other product features are fixed; it is too late to change them. Facilities have been assigned and orders have been placed with suppliers on the basis of the forecast volume, and sales and production cannot stray far from forecast volume without serious financial consequences. At this point, it is up to the sales force to move the product to the customer.

*Communication*

Once again the market analyst can assist in the job of communicating with the customer. He can help get the sales message across by providing management with facts on the advertising media that will reach the greatest number of potential customers at the least cost. He can advise on the types of advertising customers find most appealing, on the product features they find most attractive, on where customers want dealers and service facilities to be located, and on what kind of service they really want from dealerships.

*Customer Satisfaction*

Finally, we come to the last step (but certainly not the least) in the flow of information to management—that of measuring customer satisfaction with the product after it has been in the customer's possession for a

TABLE 2

**Relationship of Repurchase Intentions to "Things Gone Wrong"**

| | Percentage of Respondents Reporting Number of Things Wrong | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Buying Intention** | **Nothing Wrong** | **One** | **Two** | **Three** | **Four** | **Five** | **Six** | **Seven Or More** |
| Would buy same make | 87 | 82 | 76 | 70 | 61 | 57 | 56 | 53 |
| Would buy different make | 13 | 18 | 24 | 30 | 39 | 43 | 44 | 47 |
| Total | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Number of respondents | (3,385) | (2,929) | (1,762) | (975) | (521) | (272) | (178) | (224) |

Note: At time of interview, cars had been owned two to three months.

SOURCE: Marketing Research Department, Ford Motor Company, 1956-59.

period of time. The first project of the divisional marketing research area, which was organized early in 1951, was to survey 2,000 1950 Ford owners who had owned their cars for three months, and to compare their satisfaction with a comparable group of 2,000 Chevrolet owners.

Since these studies have been kept up to date, we now have a running record of how the Ford product compares with our major competition—not only in the areas of overall satisfaction, but in the more specific areas of styling, performance, comfort, dependability, economy, and "things gone wrong." Table 2 reports on the relation between things gone wrong and repurchase intentions.



Initially these surveys were conducted on the personal interview basis among a random sample of individuals who had purchased the new model car. In 1953 we conducted an experiment to determine whether accurate information could be obtained over the telephone. Our discovery that it could be obtained in this way almost halved the cost of the survey. Since that time, we have also discovered that a sample of 1,000 Ford owners and 1,000 competitive owners is adequate in size.

A second method of keeping posted on customer satisfaction was introduced in 1953 when we first took advantage of the J. Walter Thompson Consumer Panel, which gives us a running record of repairs on Fords and on cars of the major competitive makes. This study has not only served to give us a rough guide to the relative expense our customers face in maintaining our product versus the competition's product, but also has been most helpful in letting us know where the customer has his car repaired. Table 3 compares the amount of customer repairs on the 1959 Ford and 1959 Chevrolet.

Three years later, we undertook a joint venture with one of the largest leasing firms in the country. We now obtain information on specific customer-paid repair items by examining mileage bands for our own products and comparing them with the competition's bands. This has the advantage of giving us a faster recording of any problems that might influence customer satisfaction since fleets tend to put mileage on a car substantially faster than the average customer.

The fourth method of obtaining data on cost of repairs, a factor that has an important bearing on customer satisfaction, has been inaugurated within the last year. With this new approach, we have offered to pay for the repairs of a limited sample of customers providing they have the repair work done by the dealer from whom they purchased the car. This gives us a chance to get a more complete and specific record on each of the items; the added repair business also creates considerable dealer interest; and the customer's satisfaction at having his repair expenses reimbursed increases his loyalty.

A close follow-up on secondary sources provides a fifth way of keeping up to date on customer satisfaction with our product. Automotive surveys made by magazines such as *Look, Redbook, Fortune, Popular*

TABLE 3

**Customer-Paid Repair Costs* for 1959 Ford and Chevrolet (through 20,000 miles of driving)**

| Customer-Paid Repair Costs | 1959 Ford | 1959 Chevrolet |
|---|---|---|
| None | 12% | 9% |
| Under $10 | 15 | 14 |
| $10-19.99 | 14 | 18 |
| $20-29.99 | 13 | 14 |
| $30-39.99 | 13 | 13 |
| $40-49.99 | 13 | 8 |
| $50-59.99 | 7 | 7 |
| $60-69.99 | 6 | 7 |
| $70-79.99 | 3 | 3 |
| $80-99.99 | 2 | 4 |
| $100 and over | 2 | 3 |
| Total | 100 | 100 |
| Average customer-paid repair costs per unit | $31.16 | $33.60 |
| Number in sample | 306 | 452 |

*Repair costs here include unclassified repairs but exclude lubrication and oil changes. Data refer to cars in the middle and upper series equipped with eight-cylinder engines and automatic transmission.

SOURCE: Marketing Research Department, Ford Motor Co.

*Mechanics*, the McCall's Congress on Better Living, and recently NBC, all provide useful "outside" sources of measurement.

THE MARKETING researcher does not use a Ouija board, nor does he have occult powers. Moreover, there is still a lot to learn in the field. But there is a place in industry for careful marketing research, both in helping to decide in advance what products will have the best chance of maximizing customer satisfaction, and in measuring the degree of satisfaction after the product is on the market.

## THE SCOPE AND METHOD OF MARKET MEASUREMENT

RONALD P. WILLETT

TWO factors appear to have been responsible for the growth of the market measurement discipline: the development of applicable statistical techniques and the sporadic occurrence of problems requiring a type of market measurement. Now, however, the need for a body of market measurement logic and technique must be satisfied by the development of more orderly and better planned approaches to market measurement problems.

There are good reasons for making efforts to satisfy this need. The use potential for improvements in market measurements is great: on the one hand, there is popular acceptance of a market focus for the managing of the firm's marketing operations; on the other, computer and quantitative techniques have been systematically developed. Then, too, from a purely selfish point of view, marketing practitioners and academicians are faced with the prospect of either assimilating new measurement logic and techniques and refurbishing the existing techniques of market measurement, or seeing the confidence of decision-makers in this kind of research diminish.

First, and fundamental to the fruitful use of market measurements, we must detail the process for integrating all types of market measurements with the communications links in the firm. Market measurements must be expressed in the dimensions and language that permit immediate comprehension and application by all the functional areas of the firm. Second, the techniques of market measurement must be regrouped on the basis of logic of measurement, then detailed as to common and unique applications, the objectives being to provide a sound basis for adding new measurement logic to existing tools, and to establish the basis for competition among comparable techniques in performing a given measurement function. Third, there is a need for a comprehensive statement of the scope of market measurement including those kinds of analysis that are only concepts at this time, as well as those that are currently feasible.

Since this paper cannot hope to offer definitive suggestions covering all three areas outlined for research, an attempt will be made, first, to tackle the least controversial question, which is the definition of the possible scope of applications for market measurements.

## MARKET PATTERNS

This session of the conference has dealt with market measurement. Although such a limitation of subject should not preclude our considering all facets of consumer behavior, the following discussion, for the sake of consistency, does not consider all the possibilities of behavior measurement.

The configuration of market measurement assumed might best be termed market pattern measurement. Market pattern measurements as defined here are different in two respects from the conventional expositions of market measurements: They include the definition of the market behavior system as well as the source of demand dimension, and are treated as potential subjects for dynamic as well as cross-section or comparative statics analysis. The principal relevant classes of market patterns appear in Table 1.

In each class, analyses of varying complexity are possible. Mention of market potential, for example, usually connotes some form of nonrepetitive measurement in which any form of interpretation that takes time into account is impossible. However, each class of market pattern listed above has a number of possible stages of complexity where measurements at different times may be made consistent for comparison and projection purposes. In fact, the need for continuous market measurement and appraisal —if market measurements are to be used in decision-making—dictates that the full range of measurement possibilities be considered initially. After a review of the scope of the market measurement problem, resources available for measurement, and data availability implementation should be considered. One attempt to indicate the amount of complexity that may be relevant for each class of market pattern appears in Table 2.



## TECHNIQUES

The existing techniques of market measurement have become highly developed over the years, although they are not always applied with the same degree of sophistication. Sample survey theory, statistical inference, time series analysis, and regression analysis are all—at one time or another—applicable to

TABLE 1

### Classes of Market Patterns

**Aggregate of consumption expenditures**
Personal total, durable, nondurable, services, and so forth
Industrial plant, equipment, and so forth
Federal, state, and local government by type

**Market characteristic parameters**
Classification of type of consumer
Demographic factors including population numbers, location, age, density, mobility, and so forth
Purchase ability including income levels, income distribution, saving and saving patterns, credit, and so forth

**Detailed market potential by:**
Segment(s)
Firm's market niche
Product class and product lines
Channel class
Price class and price lines
Company division
Territory or geographic sectors

**Market-time configuration (may also be classified according to the divisions for market potential above)**
Long-run market and sales forecasts
Short-run sales forecasts

**Market competition pattern relative to:**
Segment(s) or firm's niche
Product and product lines
Prices and price lines
Channels
Promotion
Costs of manufacture and distribution
Profitability
Organization form and efficiency
Share of market
Market penetration, saturation, and maturity

**Input-output functions of the firms' marketing inputs:**
Products, product lines, product development, packaging, and branding
Channels, channel support, integration, selectivity, and margins
Prices, price lines, price changes, and price substitutes
Promotional expenditures, media, and campaigns
Personal selling

**Allocation and scheduling of firms' individual and joint effort inputs—internal programming (may also be classified according to the input-output divisions for functions above)**

**Effects of firms' total strategies given firms' total environments—simulation**

TABLE 2

## Potential Complexity of Market Pattern Measurement

| Class of Market Pattern | Complexity of Measurement: Single Aggregate | Comparative Aggregates | One-Time Cross-Section | Comparative Cross-Sections | Annual Time Series | Quarterly or Monthly Time Series |
|---|---|---|---|---|---|---|
| Aggregates of consumption expenditures | X | X | X | X | X | X |
| Market characteristic parameters | X | X | X | X | | |
| Detailed market potential | X | X | X | X | | |
| Market-time configuration | | X | | X | X | X |
| Market competition pattern | X | X | X | X | | |
| Input-output functions of the firm's marketing inputs | X | X | | | | |
| Allocation and scheduling of firm's individual and joint effort inputs—internal programming | | | X | X | X | X |
| Effects of firm's total strategies given firm's total environments | | | X | X | X | X |

the problems of market measurement. The selection of the appropriate techniques, however, can still present the researcher with a difficult decision.

In addition to existing statistical techniques, some techniques now being developed may hold great promise. Mathematical models and simulation, experimental design and quasi-experimental design, mathematical programming and scheduling, and data processing techniques may all be potentially useful in measuring markets and market patterns.

But the usefulness of these new techniques cannot be determined by trial-and-error application. The logic of measurement implicit in the use of each technique must be determined and then reviewed within the context of the kinds of market measurement problems that firms need to solve. The responsibility for this evaluation lies with marketing researchers, both business and academic.

### IMPLEMENTATION

We come now to the most difficult problem involved in implementing the concepts and practices of market measurement: Market measurement has meaning only insofar as the measurements, once developed and applied, can be translated into operational language for the decision-maker's use. Heuristic decision-making—now, and for some time in the future—will be more common than automatic or quantitative decision-making. To the extent that the idea of the firm as a system of plans, practices, and controls has gained stature, the job of implementing market measurements has been made easier. Analysis of the firm's objectives, functions, policies, and procedures generally pinpoints the need for specific kinds of planning and control information. For example, use of key result areas in the firm, such as profitability, market position, and product leadership, dictate specific kinds of market measurements. Potential market measurement needs are also revealed by the use of control points such as production rate, production volume, economic lot sizes, inventory turnover, out-of-stock situations, plant capacity and utilization, and product malfunction rates as well as by all the familiar areas of marketing control. The specification of such needs for intelligence becomes the starting point in the market measurement process.

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# PRODUCT PLANNING AND ADAPTATION

## PRODUCT PLANNING AND ADAPTATION

ALBERT HARING

DURING THE 1950's, marketing began to play an important part in product planning and the development of a product line. The two following articles discuss the reasons for the rise of marketing in the product planning field, and innovation in our economy and its direct relationship with profits during the post-World War II era. This article will summarize the issues and conclusions that appeared in discussion and case analyses.

### CORPORATE POLICY

Considerable emphasis was placed upon the fact that a company must have a broad corporate policy to avoid many pitfalls of improper product development. The following eleven points were considered.

1 The first step is to evaluate the company's present line of products. Are the current lines shrinking in importance and volume or do they show signs of a promising future? Even though a product or line of products may have a favorable volume future, the question of profits must be carefully considered. There has been a distinct tendency during the last decade for established products to have greater competition and, consequently, declining profits. Thus, the evaluation of the current line must include not only future volume but profit possibilities. In a rapidly changing economy with a tendency toward unused capacity, the profit squeeze may be the most significant factor in examining the future.

2 Management must set its broad goals for at least the next decade. The volume forecast for 1970, for example, must be carefully analyzed. The next step is to match the prob-

able sales and profits provided by the current line for 1970. Then the question of expansion or contraction arises. If the current line will not provide the goals for 1970, then the problem is to set clearly the goals for facilities, sales, and profits. The development of a product line to attain these goals then becomes much more clear. In most cases, new products or additions to old lines will be essential to attain any goal that involves significant expansion.

3 A profit goal is also vital in evaluating new products. If the profit goal should be 10 per cent of sales, some products will be eliminated and others will appear promising. The existing line should be carefully examined with respect to its profit ratio by age of product. In some industries, the long-established products have much lower profit ratios than successful newer ones. In looking ahead, many companies will find that their established products are contributing significant profits in dollars but an undesirable profit ratio.

One of the functions of the new products is to yield above-average profits during their early years so that the company average reaches the desired level. To evaluate the situation properly, products may have to be segregated not by age alone but by whether they are staples or specialities. In addition, a division by type of market may also be required. Currently, this analysis of products is very helpful in evaluating the areas that offer the greatest promise of adequate profits in the future.

4 Where a new product may require sizable investment in either equipment or a new plant, the problem of the time necessary to recover the new investment is significant. This is directly connected with profits but has additional implications. For plant expansion and large equipment investment, the corporation should set a specific number of years as the write-off period so that new product ideas can be evaluated against a standard. In a rapidly moving industry where innovation is common, special equipment might require a one-year write-off. On the other hand, in a relatively stable industry with broad markets, a ten-year write-off might be considered appropriate.

5 In what areas is the company willing to expand? One company in the chemical field chooses to limit its activities to chemical products derived from and serving agriculture. A second company may desire to limit its new products to those that are purchased by consumers through druggists and similar retailers. A third company may be completely opportunistic and feel that it can afford to expand wherever the profit potential is adequate and the write-off of new equipment is within its goals.

Most companies are not very successful in what might be called "scrambled" additions, although in some instances the profit motive alone has apparently caused illogical additions that turned out very well. The consensus, however, is that a corporation should have a definite policy as to which areas are most desirable for expansion. If the research and development division comes up with products that do not meet this requirement, the tendency would be to sell or license such products rather than to change the form of the corporate picture. For example, the National Cash Register Company sought a method to eliminate carbon paper in making copies of sales slips, cash register receipts, and similar duplications. The company developed "encapsulment," a process that has many uses far removed from the business machine and business machine supply field, but chose to license its use in other industries rather than to change the company's basic pattern. Such a policy would appear to be desirable for all except the most unusual operations.

6 For both existing lines and proposed new products, markets should be carefully examined. After analyzing the market according to the use of product and channels of distribution (an approach called market segmentation), companies often find that they are not covering the total market. Prod-

uct planning involves an advance decision as to which market segments a company should serve, a process that involves careful research and raises many problems. Should a private brand be made? Should large retailers be sold direct? Should the direct distribution of industrial goods be supplemented by industrial distributors? Should an inferior quality of a standard product be fabricated? Market segments and the products that they require vary so much that many companies have found it essential to create special departments to serve each major market segment.

**7** The proven ability of executives and personnel of a company to operate profitably in a limited area is no guarantee of success in an unfamiliar area. Stated in another manner, no new activity should be undertaken that is not controllable by the management and managers upon the basis of their past performance. For example, members of a firm that has had great success in producing top-quality items at a premium price may be completely unable to make the mental adjustment necessary to produce a low-quality product for the mass market where no premium price can be justified. Where a company's experience has been largely in the handling of metallic products, a jump over to an industry that is based on woodworking would seem to involve an unnecessarily large risk.



One company will have greater marketing strengths through certain types of channels. A second company may be very strong on research and development. A third company may be excellent in its production techniques. If a company decides to expand, it should get executives experienced in the new areas.

**8** In considering new products and growth, a company must weigh the advantages of acquisition against construction. Acquisition offers speed and secures personnel for a new line. Construction and expansion offer more modern facilities. Some sort of criteria must be developed to choose between these, so a broad company policy is usually most helpful.

**9** Every organization that is successful over a period of time develops some type of company or corporate personality. This personality may be synonymous with quality at a premium or with competitive prices. A company may have a reputation for leadership or innovation, or producing staple products at competitive prices. A company may be in good favor with individual consumers and the public, or have an excellent industrial reputation. One major requirement in product planning is to recognize the company personality and to consider limiting product development and production to those areas where the company personality is strong and favorable. Certainly, the personality and thinking of the company is a key to determining the areas where success with new products is most promising.

**10** The next major step is to evaluate the present product line. Should the company drop scrambled additions made during the 1950's or earlier, or products whose sale has been falling? Certainly, in considering a new product the existing line should be carefully examined to determine whether plant and equipment should be made available for the new product by eliminating an old one, or whether new facilities should be created. From the discussion, the general feeling was that many poor decisions have been made to expand plant and equipment when weak and fading products should have been dropped from the line.

The sales of fading products tend to be overstated because they are never in short supply, while the sales of new and rising products tend to be understated because of shortage and inability to ship. The latter condition suggests that unfilled orders are as important as shipments in analyzing the position of products now being made.

**11** No new product is likely to fit a list of criteria perfectly. As a result, the assumption must be made that every new product will involve compromising some of the criteria. The problem is to choose products that best fit the test criteria and offer the greatest probability of success. Practical compromise thus becomes basic in product decisions.

## PRODUCT POLICY

The criteria that have been discussed provide an incomplete list. With another group of participants, a somewhat different emphasis might have developed. To develop a sound product policy, each company must draw up its own list of criteria for evaluating product ideas and product planning.

Two points, however, should be emphasized. First, every business will have to evaluate impartially its own competitive strengths and weaknesses. To be realistic is very difficult; in fact, numerous companies hire consulting firms to ensure impartial analysis.

In adding Paper Mate ball-point pens and Toni hair preparations to supplement its razor and blade line, Gillette appears to have decided that its marketing skills should be concentrated in consumer products that required substantial investment in advertising and promotion. Container manufacturers, as more and more containers have shifted from tin to aluminum and plastic (and other materials), have broadened their lines to cover the container field. Automobile parts manufacturers serving the original equipment market alone have entered the replacement or "after-market." Specialty manufacturers of major appliances have expanded or combined to offer full lines. Kaiser, after securing the Jeep line, has shifted market emphasis mainly to industrial, commercial, and farm use, the areas in which its corporate picture is most favorably known. General Motors has entered the diesel-powered truck field to round out its line of trucks. Each of these companies, as well as many others, has expanded where the company management believed its competitive strengths were close to a maximum.

Second, organization for effective product planning and product development was recognized as possibly the most difficult mixture of line-and-staff relationship in today's business management. User- and market-oriented product development requires close cooperation among market research, sales, product and development engineering, engineering, production, and service (as a minimum) before the proper product, its probable market, and its profitable price can be determined. Where a new plant must be built, finance and other areas of the company become involved. In a large company, many of the executives carrying on the work are below top level, yet must deal frequently with top level men who must have the vision to treat them as equals, possibly as experts, in the particular issues under consideration. Discussion highlighted this problem, but did not suggest any easy solution. The needs for adequate early market analysis, for testing new products under actual use conditions, and for test marketing were, however, consistently emphasized.

One additional point should be made. The need for educating company executives and personnel about new product policy, once it has been established, appears to be vital. When basic policies concerning new products, product lines, and product development have been established, the people concerned must be indoctrinated with such policies and their importance. This area appears to have been so nebulous in many companies that executives interpret new product policy in diverse ways or do not regard such policy changes as significant. To implement new product policy appears to require as much effort in communications as a basic change in compensation methods. And, since many companies will rely upon products not now produced for the bulk of their profits in 1970, adequate understanding warrants whatever effort may be needed.

In comparing product development in the United States and Europe, the European participants emphasized frequently that European firms had fewer facilities and people devoted to new products. Their comment suggested that the rejuvenation of European factories and business after World War II had developed at a pace such that significant expenditures, both in personnel and equipment, had not been devoted to nor available for creative product research and development. As the European executives analyzed the world market situation, the relatively

low overhead costs abroad might make export increases from Europe practical in established products, while the United States could more than compensate for any such trade loss by expanding foreign sales of new products.

## OUR INNOVATIVE ECONOMY

D. Maynard Phelps

In recent years, our American economy has often been described as innovative. It is also called a competitive economy and accurately so, because the spirit of competition has been reasonably well preserved in most industries, despite some noteworthy instances of collusion and attempted lessening of competition through mergers. Yet it is my feeling that competition has not been substantially reduced, but that, in fact, a good case can be made for the contrary. Nevertheless, the nature of competition has changed in many, if not in most, American industries. Essentially, competition is rivalry—a striving to equal or excel others in like pursuits—that can express itself in many ways. When we say that we now have an innovative economy we are really saying that competition expresses itself more than ever before in a striving for new products and product improvements rather than through price as such or production economies.

Company executives must decide what will be most effective in capturing present markets or extending them beyond present boundaries. For instance, they may say that their forte is in the management of production, that they can produce at lower costs than their rivals, charge lower prices, and thus increase sales volume or share of market. Or, even without lower costs, they can still follow a policy of competing actively pricewise in the hope that competitors will not follow or that they will do so tardily, and thus give the price reduction initiator an advantage. But business concerns have become more and more skeptical about the virtues of price competition in similar products. They have found that price competition, under certain circumstances, is not fruitful, in that it begets more competition and all producers suffer. They feel that the advantage gained by price reduction is likely to be an exceedingly transitory one, whereas the advantage gained by developing a superior product may have more lasting qualities.

If two conditions are present, namely, little price elasticity of demand and a prompt meeting of price reduction by competitors, price reductions simply are not advantageous to manufacturers. Let us take an example from the automobile industry. Suppose, as Walter Reuther once suggested, that all automobile manufacturers reduce their prices by $100 per car in the hope of stimulating demand. Under such circumstances, no individual manufacturer could hope to sell additional cars through cross-elasticity, that is, by capturing volume from some competitor by a price reduction move. Elasticity of demand would have to be present before an increase in total demand would give all manufacturers some additional business. Studies have indicated that automobiles have a very low coefficient of elasticity at present. Under these circumstances, a price reduction would simply lower profits for all automobile producers. This is one reason why automobile manufacturers pay so much attention to product innovation in attempts to capture a larger share of an existing market. The inference should not be made that price reductions are never fruitful. In the early stages of an industry when additional volume makes possible substantially reduced production costs and much lower prices, demand can be stimulated by price reductions. Of course, this was true of the automobile industry, but it is now a prime example of reliance on innovation for competitive purposes.

Innovation enables a company to change its product line and to keep up its level of profits. When a product is first introduced, its distinctiveness, its interest for consumers, and the immediate absence of strong competition make possible a relatively long margin through a high price in relation to costs. Undoubtedly this has been true of Metrecal, the

anti-obesity preparation or, to use a better name, the weight reduction formula. Although competitors came into the market rapidly, Metrecal was and still is a profitable item for Mead Johnson & Company. But prices already have been reduced from the initial level. The point is that a company adds these profitable products to its line through innovation and thus increases, or at least maintains, the profit level. It is just as important to discontinue certain products for which further innovation seems unlikely and for which profits have dwindled—if not disappeared. Many concerns can tell us that they concluded certain products could make no profit, were not needed for purposes of a complete line, and so were discontinued. For various reasons, it is often difficult to discontinue the manufacture and sale of a product but it may, nevertheless, be the logical thing to do.

The tremendous emphasis on technical research in recent years has provided the opportunity for innovation. Of course, it might be argued cogently that the desire for innovation brought about through competition and the need for a more profitable line of products prompted the technical research. There is much research being done, however, that is not the result of competition in other than a very broad sense, so innovation is probably both the cause and the effect of research in American industry. Also, it should be recognized that research "feeds upon itself" in the sense that whatever has been done provides a broader base for an increase in knowledge in the future.

When looking for reasons behind the trend toward an innovistic economy, we must first give due credit to a maintained—perhaps even to an accelerated—competition or, as I have often said, to the instability of competitive position. Another factor is the growth of scientific knowledge and the improvement of technology. Social scientists are trying to understand the impressive wave of new products and product innovations that appeared after World War II. People throughout the world are attempting to account for the multiplicity of goods and services available in the American economy. There has been nothing like it before, anywhere, in the world's history. Perhaps it can be ascribed to the economic and social background of the United States and to pressures on the individual business enterprise.

Among the economic and social factors that have favorably affected the rate of innovation in the United States are the freedom of private enterprises to develop and market products without much interference from government; the presence of a large and relatively unfettered market; the increase in discretionary purchasing power; the inclination to assume that novel things are better than traditional ones, or at least the willingness to try new things; a vigorous and imaginative approach to business activities, including the willingness to take risk; and the quest for security in a most threatening world situation.



All of these factors undoubtedly have had some bearing on product innovation in the United States, but the principal ones, those that might be termed the keystones of the arch, are technological progress—the application of discoveries in pure science to new and profitable uses—and an active effective competition or rivalry among business concerns.

## THE RISE OF MARKETING IN PRODUCT PLANNING

E. RAYMOND COREY

THE GENERAL ELECTRIC Annual Report for 1952 contained the following statement:

> "In 1952, your company's operating managers were presented an advanced concept of marketing, formulated by the Marketing Services Division. This, in simple terms, would introduce the marketing man at the beginning rather than at the end of the production cycle and would integrate marketing into each phase of the business. Thus, marketing would establish for the engineer, the designer, and the manufacturing man what the customer wants in a given product, what price he will be willing to pay,

where and when he will want it. Marketing would have authority in product planning, production scheduling and inventory control as well as the sales and distribution and servicing of the product. This concept, it is believed, will fix responsibility, while making possible greater flexibility and closer teamwork in the marketing of the company's products."

Is this in fact an "advanced concept"? If so, what underlies what appears to be a fundamental change in approach to product planning?

Throughout its long and successful history, General Electric has been an engineering-oriented company, a technical pioneer in a wide range of activities. Whether by formal arrangement or simply by practice, the design of its product lines had become the responsibility primarily of the company's engineering personnel. Product planning was a laboratory-initiated activity. The products GE sales representatives took to the market were an expression, in good part, of the company's technical research achievements.



For General Electric and for many other technically strong U.S. corporations to conceive of product planning as a marketing function is to reverse a decision-making flow of long standing. Product planning becomes a market-initiated activity, and product lines, an expression of what marketing personnel have determined to be the needs of GE's customer groups.

## REASONS FOR THE CHANGE

What conditions, we may ask, have dictated this change for GE and for many other technically competent American corporations? Four factors, at least, may be cited. *First*, the high rate of technical development has forced companies to pay more attention to their markets. Technical research has been a competitive weapon, surpassing in its power such traditional weapons as price cutting and increased advertising. New products, unseating existing ones in the markets they traditionally claimed, became the new face of competition. These new products brought hosts of new competitors—unorthodox in approach, unpredictable and undisciplined in the time-worn protocol of industry practice. For some, research was the cornucopia of new opportunity; for others research was an uncontrollable force disrupting stable markets. The essential point, however, is that for both the challenger and the challenged the question, more urgently asked than ever before, became: "What exactly should we make and sell?"

*Second*, the postwar wave of mergers and acquisitions has had the same disrupting effect in the market place. In many instances, mergers became the answer to the challenge of new products. Thus, for example, when aluminum began after World War II to move vigorously into applications traditionally held by copper, copper companies acquired aluminum-producing subsidiaries so they could continue to serve their existing customers. Can manufacturers, such as American Can and Continental Can, acquired affiliates supplying plastic containers and other forms of packaging. The question leading to many of these mergers was, what kind of a "package of products" makes sense in the market place?

A *third* factor that served to elevate the importance of product planning as a function, and to give this function a market orientation, was the huge dollar stakes for which the game was being played. In this day of mass production for mass markets, large investments in plant and equipment could be committed by a single decision to add a new product to the line. In many cases, the manufacturing and marketing economies of scale were such that a company could ill afford to move half-heartedly into a new market. To be competitive, one needed low unit cost product; and the only low cost plants were large, highly automated facilities. Careful product planning and marketing research helped to provide cheap insurance against costly errors.

*Fourth*, even apart from the increasing rate of technical development and the wave of postwar mergers, the sheer intensity of postwar competition *per se* has provided a

steady pressure in the direction of market-oriented product planning. In the sellers' market that we experienced in this country from the end of World War II to the early 1950's, we could tolerate considerable laxity in every dimension of marketing. When companies can sell all they make, managements sense no urgency when it comes to product planning.

Starting, however, in 1951-52, demand-supply conditions changed suddenly. Not only did domestic competition become intense, but European and Far Eastern competitors began besting us in world markets. The quality of their products was good, and their prices were often low. It is not an overstatement to say that many domestic manufacturers were forced into sharp reappraisals of what they had conceived to be their competitive strengths. If we can give such reappraising a name and call it "product planning," there was a lot more of it after 1952 than before!

It may be useful to digress briefly at this point to ask what the term "product planning" means. In actual practice, it seems to involve dealing with a broad range of problems related to what a company makes and sells. At one end of the spectrum, product planning is concerned with the company's objectives and its over-all marketing strategy. At this end, we deal with such problems as: What are the basic functions that our product line is designed to perform? What are the groups and classes of customers for which this line is intended? Do we seek to serve our markets as full-line suppliers or limited-line specialists? Will we function primarily as a supplier of materials and components or as a manufacturer of end products? Will we attempt to take a position of technical leadership in our industry, or will we achieve greater success as a follower?

At the other end of the scale, product planning becomes concerned with the detail of carrying out the basic product policy. We deal at this end with such problems as: How many grades, models, and sizes do we supply in each product line? What exactly are the specifications of each item in the line? If Customer X requests certain modifications in the specifications to meet his particular needs, will we accede to this request?

By way of definition then, product planning is the determination of the company's basic product objectives, of what products the company will make and/or sell, and of what the specifications of these products will be.

### DECISION-MAKING CRITERIA

Product planning decisions often involve investigation and judgment in three areas: What does the market want? Can our company be competitively effective in this market? What will our making and selling the new product contribute to our total operations? Let us consider each of these areas in turn.



*What does the market want?* The late Charles Kettering, a pioneer in the automotive industry, was once asked in an interview whether he believed that "if a man made a better mousetrap, the world would make a beaten path to his door." Kettering replied, "The people who have mice will." This observation is striking for its clear and simple wisdom. Kettering stresses the necessity for orienting product development effort to market needs. He also suggests in his rejoinder that, in analyzing markets, we need to be conscious of the fact that every market is made up of segments. Each segment consists of a group of customers having homogeneous needs and buying motivations.

Our first task, then, is to identify the specific market segments with which we are concerned and to determine market needs as precisely as possible. We are then able to ascertain, first, whether the product under consideration actually has a market and, if so, what its specifications should be.

Simple enough to say, but we often encounter obstacles in making these judgments. In the first place, the market we have in mind may not be able to articulate its

needs if the idea of the product is relatively new. How far would we get, for example, in determining the potential market for private space vehicles by interviewing our potential customer—the man in the street? He has no way of knowing how such a product would fit into his pattern of living, if in fact it ever will. The same fundamental difficulty is present even in investigating the needs for new products that might fit immediately into the customer's day-to-day activities.

Another difficulty often exists in identifying accurately those groups that will make the buying decisions and whose ideas may then determine product planning decisions. Take, for example, the dilemma of a manufacturer of heating and air-conditioning equipment who was interested in adding heat pumps to his line. The heat pump, based on the same principles of operation as the refrigerator, heats the home in the winter and cools it in the summer with the same unit doing both tasks. This equipment could be made in one large unit and installed in the house. Alternatively, it could be made in two parts with one in the house and the other outside. The choice involved such considerations as ease of installation, quality of performance, and noise levels. In attempting to resolve this question, the manufacturer recognized that homeowners, architects, builders, heating and plumbing contractors, and distributors would all be influential in buying decisions regarding the heat pump. It was unlikely, however, that each would appraise the relative advantages of the split and the integral designs in the same way. How, then, could he appraise the relative importance of these conflicting signals, and make a product design decision?

A third difficulty in analyzing markets for new products is presented by the changing and evolving nature of these markets. The market segments of which we speak may emerge only after a product is in commercial use for a period of time. Then different groups begin to exhibit distinguishing characteristics with regard to the purchase and use of the product. At the outset, however, market segmentation may be only a latent thing.

In the face of these problems, it may be difficult, but not impossible, to make some initial judgments regarding market needs. For lack of adequate market information, marketers and engineers may have to define, as objectively as possible, what market needs are likely to be. Interviews with a few potential customers, with the company's field sales engineers, and with representatives of technical trade associations may provide them with some broad guidelines. These ideas may be enough for a first approximation of the market to be served and the product to be supplied.

The further refinement of these ideas then may come through the experience gained in the initial marketing of the product. It may be useful to recognize that the beginning phases of market development, when the new product is actually being made and sold to commercial customers, are at the same time a part of the market research effort. Introducing the product commercially, in other words, is part of the very process of finding out what we need to know about where the market exists and exactly what it wants.

*Can our company be competitively effective in this market?* It is axiomatic that, in defining its basic purpose and objectives, a company should "lead from strength." It should attempt to do those things that it can do well. In dealing, then, with product planning questions that fall at the "policy" end of the spectrum, we need to relate the company's strengths to the requirements of the specific job a management undertakes if it elects to make and market the new product.

It then becomes pertinent to ask questions such as these: Are there few or many potential customers? Can they be reached through the company's existing channels of distribution? Will extensive technical and engineering service be required by customers? Will the company need to establish new manufacturing and warehouse facilities? Are the supplier's trade reputation and brand name

important considerations in the eyes of potential customers? Will market share depend significantly on maintaining a position of technical leadership? Will market position depend on low price or on level of quality? Are existing customers also potential customers for the new product?

Answers to these questions may go a long way toward determining whether the particular assets, skills, and relationships the company possesses can be effectively employed in marketing the new product.

There is one other dimension, however, with which to deal in appraising a company's capacity for marketing a new product. This is the matter of management interests and orientation. The degree of enthusiasm—or alternatively, the degree of resistance—that is generated internally by the idea of adding a new product can be a critical consideration. The new product may, for example, compete against the existing line for certain applications. In such instances, it may be true that the sense of psychological commitments to the current line literally disqualifies the management from doing an effective marketing job with the new product.

*What will our making and selling the new product contribute to our total operations?* Instinctively, the first question asked regarding the addition of a new product to the line is: How profitable will it be? While this may be an appropriate first question, it is often not the key question. And very often a product planning decision is made not simply to increase profit but to accomplish some other objectives related to the business as a whole.

It may be desirable, for example, to add certain products to have a full line of products going to certain customer groups. Or the product may be added because the company's distributors want it and will turn to other sources of supply if the company does not add it to the line. Again, improvements in product specifications may be made simply to meet the threat of a competitor's improved product and thereby to retain market position.

On the other hand, new product ideas may be considered and rejected because of their potentially adverse impact on some part of the company's business. Making and selling the new product may put the company in competition with some present customers. Or selling the new product might seem to existing customers to be in conflict with the company's image. A manufacturer of electric fork-lift trucks, for example, who had claimed for years in his advertising that electric trucks were superior to gas trucks would face some difficulty in adding gas trucks to his line.

Judgments regarding the impact of a new product on the company's total operations are not easily made. For one thing, it is often not possible to apply quantitative measures in this area. Nevertheless, tough-minded and objective judgment is called for to avoid making decisions based on emotion and short-run considerations.



PRODUCT PLANNING may be defined as the determination of the company's basic objectives, of what products it will make and sell, and of what the specifications of these products will be. Product planning as a marketing activity has gained greatly in importance in the last decade. Reasons for the increase are the high rate of technological development, the postwar wave of mergers and acquisitions, increasing competition in world markets, and the mounting costs of new plants. These factors have tended to increase both the number and the significance of decisions corporate managements must make regarding what products the company should make and sell. They have forced management to give increasing effort to the task of designing competitively effective product lines.

In making product planning decisions, the relevant factors seem often to fall in three areas of consideration: What does the market want? Can the company be competitively effective in this market? What will making and selling the new product contribute to the company's total operations?

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# MARKETING CHANNELS AND INSTITUTIONS

## CHANNELS OF DISTRIBUTION—ONE ASPECT OF MARKETING STRATEGY

WILLIAM R. DAVIDSON

IN RECENT years, increasing emphasis has been placed upon modern concepts of "customer-oriented marketing management"; it has become more and more common to administer marketing activities with reference to some defined marketing strategy.

The formulation of a marketing strategy[1] consists of two steps:

1 Identification of a market target: the selection of an objective stated in terms of the segment of the market (group of consumers or industrial users) to which the company wishes to appeal.

2 Development of a marketing mix: the choice of the relative emphasis to be accorded to different aspects of the total marketing effort, in order to best attain the objective of reaching the identified market.

While the number of separate, identifiable aspects of the total marketing effort will vary from one company to another, it may be helpful to enumerate some rather common ingredients. These are: marketing research, product planning, channels of distribution, physical availability of product, advertising and sales promotion, personal selling, and pricing.

Decisions concerning the relative emphasis to be placed upon each aspect involve alternative uses of marketing man power and capital resources. Within a particular company at a given time, it is not possible to increase greatly the relative emphasis upon one aspect without decreasing the relative importance of other ingredients of the marketing mix. Hence, decisions that enlarge

[1]For further discussion, see Alfred R. Oxenfeldt, "The Formulation of a Market Strategy," in Eugene J. Kelley and William Lazar, *Managerial Marketing: Perspectives and Viewpoints* (Homewood, Ill.: Richard D. Irwin, Inc., 1958), pp. 264 ff.

or reduce the importance of one item in the mix can be made intelligently only by considering the potential effects of changing the relative importance of others, and by evaluating the total impact of such changes upon the firm's ability to reach the market identified in the first step of formulating a marketing strategy.

These introductory remarks set the stage for viewing channels of distribution as one aspect of marketing strategy. While such channels can be singled out for special attention and discussion, managerial decisions concerning the selection of trade channels and maintenance of relationships with agencies in these channels should be made in the light of their relationship to an overall strategy of marketing.

This discussion will deal primarily with the marketing of consumer goods within the domestic market. This restriction offers some advantages. First, channels are usually lengthier and more complex in consumer goods marketing than in the industrial goods field, even though important generalizations apply equally under similar conditions. Furthermore, discussion of channel problems in industrial marketing tends to be more difficult, because of different vocabulary and operating conditions among industries; in consumer goods marketing, on the other hand, all of us have the perspective and experience of consumers, and hence can more readily grasp the implications of examples and generalizations.

## CHANNELS DEFINED

The term "channel of distribution" is part of the working vocabulary of every business executive, yet many would be hard pressed to define its meaning precisely. This is not surprising because a wide variety of interpretations are available in the literature on the subject.

For example, the channel has been defined by one author as "the pipeline through which a product flows on its way to the consumer. The manufacturer puts his product into the pipeline, or marketing channel, and various marketing people move it along to the consumer at the other end of the channel."[2]

Another authority states, "Marketing channels are the combination of agencies through which the seller, who is often, though not necessarily, the manufacturer, markets his product to the ultimate user."[3]

A third scholar views marketing channels as consisting of "intermediary sellers who intervene between the original source of supply and the ultimate consumer." In his view, the number and character of such intermediaries "are determined primarily by the requirements of sorting and by the opportunity to effect economies by suitable sorting arrangements."[4] On another occasion, the same writer described a marketing channel as a group of firms that "constitute a loose coalition engaged in exploiting a joint opportunity in the market."[5]

Another well-known source states that "the trade channel is made up of the middlemen who move goods from producers to consumers" and that "we usually think of the channel as being made up of those merchants who own the goods and of those agent middlemen who effect sales."[6]

This variety of viewpoint leads to lack of clarity on several points. Does the channel have to do primarily with the change of ownership of goods or with the physical movement of product? Is the nature of a given channel determined by the manufacturer, acting as a seller, or by middlemen and consumers, carrying out their role as buyers? Is the channel made up only of middlemen or intervening intermediaries, or does it include the manufacturer at one end and the consumer at the other?

[2]Richard M. Clewett, *Checking Your Marketing Channels* (No. 120; Washington: U.S. Small Business Administration, Management Aids for Small Manufacturers, January, 1961).

[3]John A. Howard, *Marketing Managements: Analysis and Decision* (Homewood, Ill.: Richard D. Irwin, Inc., 1957), p. 179.

[4]Wroe Alderson, *Marketing Behavior and Executive Action* (Homewood, Ill.: Richard D. Irwin, Inc., 1957), p. 211.

[5]Wroe Alderson, "The Development of Marketing Channels," in Richard M. Clewett, ed., *Marketing Channels for Manufactured Goods* (Homewood, Ill.: Richard D. Irwin, Inc., 1954), p. 30.

[6]Paul D. Converse, Harvey W. Huegy, and Robert V. Mitchell, *Elements of Marketing* (Englewood Cliffs: Prentice-Hall, Inc., 1958), p. 119.

Given some product to be marketed, several jobs must be done. First, there is the question of arrangements for bringing about changes in ownership by performance of the functions of exchange, buying, and selling. Second, there is the matter of availability of physical supply, which involves the functions of transportation and storage, and related activities such as physical handling and control of inventories. Third, there is the necessity of various facilitating or auxiliary functions, such as the collection and dissemination of marketing information, management of market risks, financing of marketing activities, and standardization and grading.

Generally speaking, the functions of exchange may be considered as paramount because planning for physical supply and performance of facilitating functions do not become relevant in the typical marketing organization unless there is profitable opportunity for transfers of ownership.

It appears, therefore, most realistic to define the channel of distribution as consisting of "the course taken in the transfer of title to a commodity."[7] It is the route taken in transferring the title of a product from its first owner (usually a manufacturer) to its last owner, the business user or ultimate consumer. Such a route necessarily includes both the origin and the destination; hence, it should be viewed as including the manufacturer and the ultimate consumer, as well as any intervening middlemen, inasmuch as all three are originators and performers of much marketing activity. Middlemen in the channel include both merchants, who assume title and resell on their own account, and various kinds of agents or brokers, who do not take title but are nonetheless instrumental along the route taken to effect transfers of ownership. Broadly speaking, the channel also includes marketing establishments owned by vertically integrated companies, that is, those performing marketing functions on more than one plane or level of distribution. Examples are chain-store distribution warehouses and manufacturers' branch sales offices. There is no legal transfer of title between a factory and a sales branch operated by the same company nor between a chain-store warehouse and the retail units it serves; however, there are intracompany transactions that have the nature of sales or shipments, and which are comparable in nature to the transactions made by alternative suppliers or distributors performing similar functions on the same plane of distribution.

### PHYSICAL DISTRIBUTION

The general tendency is for the physical flow of merchandise to accompany the route of exchange. This is not, however, universally the case, and there are indications that separate structural arrangements for physical distribution are increasingly important. A few examples will illustrate a variety of arrangements for providing physical supply apart from the channel of distribution.

In the field of **industrial marketing** and in many lines of consumer goods, manufacturers' agents are used in lieu of manufacturers' sales branches. In combining the product lines of several manufacturers, the manufacturers' agent provides economical sales coverage of a given area, and often reaches certain customers who would be difficult to contact by other means. While such agents are links in the channel used to effect transfers of title, they do not ordinarily carry stocks. The physical flow of goods is another arrangement, one that is usually direct from the factory to the customer of the agent.

In the **wholesale paper trade** (as in many other lines of wholesaling), most transactions are handled from warehouse stocks owned and stored by the merchant. A large proportion of the total dollar and physical volume of sales consists, however, of so-called "direct" sales. On individual orders of large size, the wholesale merchant buys from the manufacturer and takes title at the point where merchandise is loaded on

[7] Theodore N. Beckman, Harold H. Maynard, and William R. Davidson, *Principles of Marketing* (New York: The Ronald Press Company, 1957), p. 39.

cars, but the merchandise itself flows directly from factory to customer as a drop shipment, never coming near the establishment where the sale was negotiated.

Several retail **mail-order companies** have worked out arrangements to establish catalogue order departments in retail establishments operated by supermarket chains. While the facilities of another retailing organization are used as part of the route through which sales contact is made with the consuming public, the merchandise is shipped directly from the mail-order establishment.

In the field of **food-product manufacturing**, several companies with factories located in various parts of the country and wide product lines have recently established gigantic regional food distribution warehouses. Such warehouses consolidate in each region, a reservoir of all products in the line, permitting fast delivery of mixed cars at low freight rates to wholesalers and chain warehouses. This form of physical distribution tends to be separate from organizational responsibility for sales handled through branch offices or through food brokers, and the geographic flow of merchandise does not correspond to the location of establishments responsible for making sales contacts with customers.

In the **appliance industry**, some wide-line manufacturers have concentrated a physical supply of various items in the line, either by centralizing all manufacturing facilities or by providing for distribution warehouses. The wholesale distributor remains as the institution making sales contact with the retailer and assumes responsibility for developing the desired share of available market potential in the area of his operation. Many types of dealers at the retail level are able to purchase full cars containing a mixture of various items in the manufacturers' assortment, with the flow of goods direct from factory or manufacturers' warehouse. The retailer still has contact with the wholesaler as the next link in the distribution channel but, in many instances, this is related to transfer of title, financing arrangements, and sales promotion assistance, and has little to do with the physical flow of merchandise.

The last two examples, in particular, reflect a growing tendency to streamline physical distribution by setting it apart from the complex of channel links used for obtaining sales. In some companies, a new department of physical distribution combines a number of previously scattered activities, including finished goods inventory control, transportation and traffic warehousing, order processing, container design, and sometimes even manufacturing scheduling.[8]

As this practice becomes more widespread, there will be an increasing tendency to consider institutional arrangements in the channel used for effecting changes in ownership to be an element in the marketing mix, distinct from the arrangements for the availability of physical supply. In the majority of instances, however, both ownership changes and physical flow may continue along all or a major part of the same route.



### CHANNEL "COMMANDERS"

In many discussions of the subject, the manufacturer is cast in the role of "commander" of the channel situation. When introducing a new product or when making a major change in distribution policies, he examines a wide range of possible alternatives with respect to kinds and numbers of wholesale and retail outlets, weighs a number of factors that have a bearing upon sales volume, costs, and profitability, and selects the arrangements that best serve his purpose.

The types of decisions to be made by a manufacturer in choosing a channel may be divided into two classes: vertical considerations, which relate to the number of different levels or stages in the route used to effect transfers of title; and horizontal considerations, which pertain to the density or selectivity of distribution and the classes and

[8] "New-Fangled Routes Deliver the Goods—Faster and Cheaper," *Business Week* (Nov. 14, 1959), pp. 108 ff.; John F. Magee, "The Logistics of Distribution," *Harvard Business Review*, XXXVIII (July-Aug., 1960), 89 ff.; Edward W. Smykay Donald J. Bowersox, and Frank H. Mossman, *Physical Distribution Management* (New York: The Macmillan Company, 1961).

number of outlets on a given plane (for example, wholesale or retail level).[9]

Vertical choices may be illustrated by alternatives of the following kind that might be available to a manufacturer of home furnishings. He could choose (1) to sell direct to the consumer without use of any middlemen, perhaps by means of catalogues; (2) to sell to retail furniture stores by means of a manufacturer-employed sales organization; (3) to sell to furniture stores through wholesale merchants; (4) to sell to wholesale merchants by means of manufacturers' agents who also sell other related lines; (5) to use manufacturers' agents who call directly upon retailers; or (6) to use some combination of the above channels in order to reach different geographic markets or various classes of stores, perhaps differentiated on the basis of sales volume.

Horizontal choices may be illustrated by listing the channels open to a manufacturer of home furnishings who has his own sales organization calling directly upon the retail furniture trade. He must decide whether to (1) continue confining his distribution to retail furniture stores; (2) sell also to furniture departments in regular department stores; (3) offer his merchandise also to variety-department stores operated by certain variety chains who are expanding their merchandise offerings of this general type of merchandise; or (4) sell to various forms of discount houses.

Conventional discussions of channel problems have tended to devote more emphasis to questions of the vertical kind by stressing the factors that determine whether or when it is feasible for the manufacturer to move forward in the channel, assuming within his own organization the functions normally performed by various types of middlemen. He thereby carries his own marketing effort as close as possible to the final user. Among the various factors generally believed to contribute to the feasibility of short channels are a high unit value of product, a wide line of items marketed together, geographically concentrated markets, and financial strength and marketing know-how in the manufacturing company's organization.

In recent years, several factors have tended to make decisions of the horizontal type appear as matters of greater decision-making significance. For one thing, various types of retail outlets have greatly diversified their merchandise offerings, thereby invading what was once considered the private province of establishments in other categories. As a consequence, there is a wider range of alternatives at the retail level, and each class has unique operating problems, buying procedures, and operating philosophies. Second, choices at the horizontal level are more likely to cause frictions and tensions in channel relationship. For example, antagonism among regular household appliance stores and a possible withdrawal of sales support by them may occur when a manufacturer decides to aggressively solicit business from various types of discount houses. Similar frictions exist at the wholesale level when distributors in one line of trade find that new outlets in another trade classification are selling identical products formerly distributed in a more confined way. Third, decisions to use particular types of outlets at the retail level—a horizontal choice—may often dictate the kind of channel to be used in a vertical sense, since the retailer customarily uses certain sources of supply and a traditional outlook on buying arrangements.

### *The Middleman*

In numerous situations, the manufacturer can realistically be regarded as the channel commander, at least in the short run. It is rather common for the manufacturer to call the plays when he is large and powerful, when he has developed high public status by his demand creation activities, when he finds it feasible to use a limited number of distribution outlets, and when distribution outlets operate under the terms of a franchise and would be seriously handicapped by the withdrawal of it. This tends to be the case with automobiles, major household appli-

[9]For more comprehensive treatment, see *Principles of Marketing*, pp. 39 ff.

ances, and automotive petroleum products sold through gasoline service stations.

In many other instances, the manufacturer is channel commander not in any basic way but only in a derivative sense, owing to the strong position of middlemen in the channel. This circumstance stems from the twofold role of middlemen as distributors of manufacturers' goods and as suppliers of the purchasing requirements of their customers. When the middleman carries a variety of items drawn from many original sources, he tends to be more strongly oriented to the latter role than to the former.

Briefly, it may be noted that the manufacturers' freedom to select among conceptually available alternatives is practically limited by conditions and attitudes prevailing among middlemen. Many circumstances limit the potentialities for distribution in certain types of channel situations, whether the choice be of a vertical or horizontal nature. Examples of these circumstances follow:

The manufacturer finds that the most desirable types of outlets have already been pre-empted by strongly entrenched competitive organizations.

The middleman, already using his space and capital resources to the maximum, is reluctant to add additional items to his line, since such proliferation poses serious logistics problems, particularly in terms of available display space, warehousing space, catalogue or stock control listings, capital required for inventory investment, and so forth.

The pricing or discount structure on the item is not sufficiently attractive to induce middlemen to devote promotional effort adequate to ensure movement to the consumer.

The manufacturer mishandles consumer packaging or shipping containers so that neither is acceptable under the conditions of selling or merchandise handling typical in a particular line of trade.

The manufacturer has created tensions or frictions in trade channels, either by using distribution techniques that place him in direct competition with some possible outlets or by distributing through various outlets in different lines of trade with varying margin and sales supporting requirements. He thereby generates antagonism, which makes his products unacceptable or, at best, only marginally acceptable to certain types of potential outlets.

When the manufacturer encounters conditions of such a nature, he often learns that the middleman, in his role as a buyer and selector of sources of supply, really determines the nature of the channel of distribution.

*The Consumer*

Even when middlemen, whether they be wholesale distributors or retailers, are more strongly entrenched than manufacturers as channel commanders, their role too is more derivative than basic, owing to their need to adjust to constant changes. In a private enterprise economy characterized by high levels of buying income per family, the consumer has a wide range of choices when it comes to satisfying those wants that can be met in the market place. The consumer can, for example, decide whether to use more of his purchasing power to eat better, to travel more, to buy more clothes, or to purchase new appliances for his home. If the choice is for appliances, he can satisfy his needs at a department store, an appliance store, a mail-order company, a furniture store, a discount house, an automobile accessories store or, in some areas, a supermarket or consumers' cooperative organization. His choice will ordinarily be the outlet that has best harmonized its marketing mix with the buying interests of the group of consumers of which the individual purchaser is a member.

In the long run, therefore, the buying decisions of consumers determine the adjustments that occur in the relative importance of different kinds of channels of distribution. As adjustments occur at the retail level, they naturally have their impact in a vertical sense, by modifying the relative positions of various kinds of channel links between the manufacturer and the retailer.

## CHANNEL CHOICE

The discussion thus far indicates why certain manufacturers have found it necessary to modify their concept of factors that determine the choice of channels. In the company that follows a program of modern, consumer-oriented marketing management, con-

siderations relating to consumer requirements are elevated to paramount status, and factors relating to company situation are subordinated, at least in the sense that the latter must be adjusted to the former. This means that the manufacturer must look beyond his own circumstances and beyond the situation of intermediaries in the channel, so that he is attuned to the wants and interests of the consumers in the market segment he is trying to reach.

*Evaluating Channel Relationships*

Too often, channel relationships do not receive due attention since they involve matters that are "outside" the company and, hence, are more easily taken for granted than other activities such as marketing research, advertising, or personal selling. These "internal" functions come up for more frequent review or appraisal since responsibility for them tends to be fixed on the organizational chart or in job descriptions, and the cost of them is conspicuously identified on accounting statements.



In manufacturing companies, opportunities for more frequent and more realistic appraisal of channel problems and relationships might be provided by new approaches to charting the organization of marketing activities. A new version of an organization chart might well show not only the various departments within the marketing division of the company, but also all of the vertical links in the channel used to effect transfers of title to eventual users, and, moreover, the different types of outlets on each horizontal plane or stage of distribution.

A related possibility is to prepare operating statements that reveal sales performance and cost situations through the channels used. At the top of such a statement would be sales, stated in terms of prices paid by the ultimate user, and showing as expenses the costs of marketing through the various channels in use.

IN ANY EVENT, manufacturers will have made progress in solving channel of distribution problems when they recognize two considerations. *First*, channel activities must be thought of as only one aspect of the total marketing mix and one that must be coordinated with other ingredients, as these contribute to the objective of reaching a defined market; *second*, in the long run, the nature of channels is determined from "the bottom up" rather than from "the top down."

## THE WHOLESALER AS A LINK IN THE DISTRIBUTION CHANNEL

PAUL L. COURTNEY

ALL MIDDLEMEN have one thing in common—they are too often looked upon by the general public as anachronistic appendages, useless leeches on the economy, adding cost but no value to the goods they handle. Strangely, the large national manufacturer who arranges to distribute his products through his own middle-channel facilities and the large national chain retailer who buys direct and performs his own wholesale function seem to escape this general public indignation. All middlemen, particularly we merchant wholesalers who handle the bulk of the nation's output, are solely responsible for this national misunderstanding of our role in the service of the consumer. However, we are, I hope, beginning to wake up to the fact that, as an industry, we had better do something about this misunderstanding if we are to continue to serve and prosper.

The Census of Business (1958) indicates that there are approximately 287,000 wholesale establishments in the United States and that approximately 185,000 of these are "merchant wholesalers." Merchant wholesalers are defined as "wholesalers who take title to the goods they sell such as wholesale merchants or jobbers, industrial distributors, voluntary group wholesalers, exporters, importers, cash-and-carry wholesalers, drop shippers, wagon distributors, retailer cooperative warehouses, terminal elevators, and cooperative buying associations." (I am not convinced that there are 185,000

merchant wholesalers if we stay with the definition. Thousands of retailers in the country, who buy in quantities as large or larger than many wholesalers buy, classify themselves as wholesaler-retailers. Conversely, in many commodity lines there are many wholesalers, true merchant wholesalers under the definition, who operate one or more retail outlets.)

In addition to the 185,000 merchant wholesalers, there are 102,000 wholesale establishments that can be classified as follows: "(1) Sales branches and sales offices (but not retail stores) maintained by manufacturers or mining enterprises apart from their plants or mines for the purpose of marketing their products; (2) agents, merchandise or commodity brokers, and commission merchants; (3) petroleum bulk stations; and (4) assemblers, buyers, and associations engaged in the cooperative marketing of farm products."

The public, and too many others who should know better, seem to feel that someone can wave a magic wand and the middle-channel distribution function can be bypassed, its cost eliminated, and consumer prices thereby lowered. So far as I am concerned, you can eliminate a wholesaler from the distributive system but you cannot eliminate his function — *someone has to perform it.* I must add, however, that wholesalers do not pretend that they can and do market all types of grown, mined, or manufactured products. I have never met a wholesaler of battleships, tankers, atomic cannon mounted on railroad cars, or steam-electric or hydroelectric power plants for million kilowatt power stations. We do believe, however, that in the marketing of the majority of widely distributed products of our farms, mines, and factories, some form of middleman can best perform the middle-channel distribution function.

This has been amply proven in the past century and a half in America. A few statistics are worth noting. In the past nineteen years, 1939-58, the growth in gross national product in the United States has been 480 per cent. In the same period, using the same dollar measures, the growth in dollar volume of goods handled by merchant wholesalers has increased by 533 per cent. This volume increase was handled by only 85 per cent more establishments and with only an 82 per cent total increase in number of employees in the nineteen years. I do not believe that the constantly improving efficiency of the nation's merchant wholesalers could be more dramatically emphasized.

Just as our products are constantly changing, our national marketing patterns are constantly in a state of evolution. The dyed-in-the-wool wholesalers or group of wholesalers who fail to detect changing marketing patterns and who resist changing their services to meet these changing conditions inevitably experience difficulty in just keeping up with the growth in gross national product. Ours is a consumer-dominated dynamic economy, and the vast majority of American wholesalers in almost all commodity lines are dynamic marketeers. They are cutting marketing costs while increasing services to both their suppliers and their customers.

Despite these accomplishments, why do wholesalers continue to be criticized? There are three explanations: misunderstanding about marketing in general, a negative image of wholesaling in the average American's mind, and the direct selling efforts and claims of a number of individual manufacturers coupled with the more recent direct buying and "discount" or "wholesale" selling efforts of some retailers.

To the extent that all marketing is suspect, distribution as an integral subdivision suffers. A number of important writers have leveled their critical sights on marketing activities—particularly advertising and selling. John Galbraith defends the existence of marketing—but in a backhanded way. Selling and advertising, he claims, are the products of an opulent society, rich enough to support the luxury of waste. In his words:

> " . . . Our proliferation of selling activity is the counterpart of comparative opulence. Much of it is inevitable with high levels of well-being.

It may be waste but it is waste that exists because the community is too well off to care."[1]

Marketing, to be sure, is not above reproach; there is considerable room for improvement. But to caricature all marketing as manipulative, frivolous, and even collusive advertising and selling is to miss the point. Production does not create its own demand nor is the market place aware of and ready to buy all desirable products. The legitimate wants of consumers are seldom entirely rational and economic. Psychological and sociological studies remind us that so-called nonrational needs are fundamental to human satisfactions.

To put it another way, marketing creates values or utilities. Yet how often do we forget this; how often do we talk about the "values added by manufacture" versus "the costs of distribution"? This is loaded terminology with unfortunate and inaccurate implications. Both wholesalers and retailers create value in the form of time, place, and possession utilities.



### WHOLESALER'S FUNCTION

What are the values created and the services performed by the wholesaler for his supplier? First, he plans local distribution—timely, simultaneous, nationwide distribution, with a minimum number of supplier contacts. Second, he provides a ready-made local sales force; he can economically cover a wide range of retail and industrial accounts. Third, he provides low-cost warehouse, field storage, and delivery facilities.

Fourth, he simplifies credit and accounting procedures and provides the necessary capital to finance inventories and credit extension. Last, he accepts large shipments, thus achieving substantial transportation and paper-work savings.

Without the services of the wholesaler, the direct-selling manufacturer-supplier is confronted by many problems. His efficiency must either be diluted by dividing the administrative and technical skills of his personnel between making the product and performing the middle-channel marketing function, or he must have two separate divisional functions, one to handle manufacturing and one to handle selling and distributing. Without the wholesaler he must contact a myriad of small local accounts. His often limited line of merchandise must bear the full cost of these calls, and his credit department must stand the burden of investigating and carrying hundreds or thousands of unknown risks. Unless he maintains field stocks, he must ship in thousands of small lots. Perhaps most significant is the fact that, without a nationwide, organized middle-channel group of wholesalers, the small manufacturer-supplier is limited to a local or area market for his output.

Then, too, the wholesaler performs a variety of functions for his customers—retailers and business users. He anticipates their requirements and maintains an inventory tailored to meet these requirements; he assembles, locally, the varied output of many suppliers, holding it available for calls on short notice; he buys large quantities, breaking bulk to suit the customers' convenience, while passing on the savings effected both in cost and transportation; he delivers promptly according to need; he extends credit; he guarantees the goods and makes on-the-spot adjustments, handling returns and allowances, and eliminating correspondence; he lends marketing assistance and advice (this service, moreover, is being improved in most commodity lines); and he provides financial assistance in times of stress.

This is no mean list of benefits. I submit, however, that there is more to this story. The retailer, like the supplier who uses the wholesaler's middle-channel services, avoids diluting the energies of his executive staff; he has access to a large group of products of small manufacturers that might not otherwise be available to him; and, dead-weight

[1]John K. Galbraith, *American Capitalism* (Cambridge: The Riverside Press, 1952), pp. 101-104.

store space, formerly devoted to merchandise storage, can be converted to profit-making selling or customer service space.

## TRENDS IN MARKETING

We have referred to suppliers who bypass distributors, and we know that retailers have assumed some wholesale functions and consumers some retail functions, particularly in the supermarkets and the discount houses. But how do we know that these pressures won't eventually engulf the merchant wholesaler and make him an anachronism? We can answer this question only, I believe, by examining some important marketing trends.

We all know about the growth in advertising among manufacturers who want to "presell" their products. This growth is relatively new in American marketing. How many of our sales managers of the 1930's, for example, talked about brand images and motivation of consumers? Yet these are common terms in advertising today. We wholesalers are aware that the manufacturer who invests heavily in advertising will fight to control his distribution, particularly at the retail level.

These brand efforts by manufacturers have had other effects. Not too many years ago the consumer was loyal to her favorite retailer. She was, as we might say, institution oriented. Today, her loyalty is to offerings, not institutions. Brand advertising has convinced the buyer that quality and service are the same, regardless of the retailer. The buyer is interested in self-service (anyone's self-service), stamp plans (anyone's stamp plans), and discount buying (anyone's discounting). As a result, the wholesaler and the retailer, both links in the distribution channel, are being squeezed from from two directions — from manufacturers who want controlled distribution and from consumers who have less and less respect for institutions and more of the what-can-you-do-for-me attitude. Nonetheless, I feel there are strong counteracting trends.

Manufacturers who spend large sums on advertising, particularly on national TV, need intensive distribution prior to the individual program presentation. Costs for TV are too high and the impact, though great, too short-lived to allow for so-so distribution. Thus there is a compelling reason for supporting the middle-channel, independent merchant wholesalers who can collectively effect timely broad-based distribution.

A number of manufacturers, moreover, are beginning to think in terms of segmented markets rather than large single-approach markets. There appears to be good reason for this change. The successful manufacturer experiments constantly with his product line. Innovation is necessary in an affluent economy where consumers can and do exercise their whims. The American consumer has passed the stage of having to devote his income to the necessities; now he has discretionary spending power, which can be used to choose between a second car, another TV set, a dishwasher, or perhaps a boat. Manufacturers find competition for this market rigorous indeed. There is equally severe competition for the producer of industrial goods. Plastics vie with metals, aluminum with steel, and atomic power with traditional fuels.

### *Approach to Markets*

Partly as a result of these changes, I submit that manufacturers are beginning to reappraise their basic approach to markets. Traditionally they have argued for standardized products to minimize factory costs. This standard output was sold in what was essentially defined as a homogeneous market by means of large advertising, promotional, and selling expenditures. To increase his share of the market, the producer increased his advertising and selling costs.

But this becomes frightfully expensive if the market is not homogeneous or is wealthy enough to pick and choose. To convert marginal customers to a limited product line calls for disproportionate increases in selling costs. Why not reverse the approach by pro-

ducing differentiated products that can be marketed separately to separate markets? Factory costs may rise but selling, advertising, and distribution costs will drop, and total profits may be larger. Such a manufacturer thinks in terms of the middle-channel distribution specialist, the merchant wholesaler. It is through them that he can best afford to cover a number of regional and specialized markets. Segmented markets tend to force abandonment of direct selling efforts.

Some notable recent examples of such change, covering a wide variety of commodities, might be cited: H. J. Heinz Co. and Swift & Co. in food; Crane Company in plumbing and heating; and Pratt & Whitney in industrial supplies. All have abandoned direct selling market programs in the past few years.



*Labor*

A final influence that tends to force the use of the merchant wholesaler in the middle channel of distribution is labor. Labor is becoming our scarcest and most expensive commodity. In 1929, wages and salaries constituted 59 per cent of personal income in the U.S. By 1955, it had risen one-fifth to 71 per cent. At the same time, the decrease in the number of unborn babies of the great depression showed up as a gap in our prime labor age brackets. In the 25-34 age group, for instance, an absolute decrease is taking place now. What does this mean?

With rising labor costs, a supplier-manufacturer will think twice before he duplicates an existing distribution system. Moreover, as labor costs rise, it would seem inevitable that the manufacturer will try to minimize his fixed costs of distribution in order to gain the utmost profit leverage from any sales increase. If he examines his return on investment possibilities, he is almost sure to turn to middle-channel merchant wholesalers who are geared to low-margin operations at high turnover.

However, we wholesalers do not believe that these distribution gains will be automatic. We have a job on our hands, convincing our suppliers and our customers that we can help solve their complex marketing problems. Manufacturers cannot be expected to turn their backs on large advertising commitments or to lose their desire for aggressive representation at the retail level. Nor can customers be expected to support "traditional institutions" because they are traditional.

We wholesalers are aware of early rumblings that would seem to portend a different approach to the total problem of physical distribution. Aided by new mathematical techniques (popularly labeled "operations research") and by the availability of electronic data processing equipment, manufacturers are beginning to analyze their problems of physical distribution, relating the requirements of plant capacity and location, product and package size, field warehousing, materials handling, and connecting transportation facilities. These requirements are studied as a unit for the purpose of finding the combination that will produce the greatest over-all net return on investment.

We wholesalers have been prone to think too much in terms of return on sales, gross margins, and net margins instead of the en-

lightened measure of business operating efficiency—return on investment. We will do well to remember that distributive values or utilities are not our monopoly by virtue of title. The function, not the institution, is the more enduring. Innovation is as crucial for us as it is for our suppliers and our customers. We must—in fact, we are—adapting to our changing masters—our suppliers and our customers. We are modernizing our plants, facilities, and operating procedures.

By and large, we are small companies, an advantage of great importance in local market operations. We are more responsive to changing market conditions in the local areas of final sale, and we can reflect and report these changes quickly. We believe that by increasing the flow of goods from producer to consumer we can deliver to our suppliers and our customers a "profit per transaction" that is more attractive than slower, more expensive direct distribution.

The 1960's are already showing signs of becoming the decade of not only specialization but also the "profit squeeze." We believe that alert manufacturers, large and small, and alert retailers, chain and independent, are beginning to calculate profits, as we are, on the basis of return on investment rather than return on sales. We believe that when return on investment becomes the basic tenet of management philosophy, we wholesalers will emerge as a "new source" of profit improvement, a way out, if you like, of the profit squeeze.

## THE RETAILER AS A LINK IN THE DISTRIBUTION CHANNEL

CHARLES Y. LAZARUS

THE ROLE of the retailer in the distribution channel, regardless of his size or type, is to interpret the demands of his customers and his potential customers, and to find and stock the goods these customers want, when they want them, and in the way they want them. This adds up to having the right assortments at the time customers are ready to buy. The problem today is complicated by our changing population—changing in terms of age and youth, and in terms of levels of economic income.

Types of retail operations today range from the tiny to the huge, from the neighborhood variety store to the big department store (whether downtown or in a regional shopping center), from the exclusive apparel shop to the discount house, and from the full-service store to the self-service supermarket. The population explosion, the growth of the productive capacity of America, the rise in personal income, and the resulting increased discretionary spending power have created this great diversity of retail stores; retailing reflects changing consumer demands and the way the consumer expresses these demands.

The discount house, for example, is a phenomenon of the postwar economy. It was made possible by the pressure of productive capacity developed during the war years, particularly for hard goods, and by the need for distributing the goods produced. Many discount-house techniques of pricing and methods of selling have been adopted by other forms of retailing, and even a store like ours is in the discount business in many lines.

The new specializations concern price levels as well as types of goods. "Budget" and "better" apparel shops, children's apparel shops, maternity shops, junior size shops, greeting card shops, and hobby goods shops are but a few. Most of these specializations are paralleled in the large department stores. As an example, take the men's departments in our store. Before the war, we had a men's furnishings department, a men's clothing department, and a University Shop for the younger man; but new specializations have developed each season in men's lines. As the work week became shorter and vacations were extended, the casual sportswear trend grew, and more men wanted a varied wardrobe. This spring, as a result, we opened two clothing departments (a budget and a better), two complete sportswear de-

partments (a budget and a better), plus the University Shop; in the next few months, we will open a specialty shop beamed at the young man who wears "natural shoulder" clothing. Besides these departments in the main store, we have a series of specialized men's shops in our basement store. Each specializes in a type or price level of men's wear. The male customer, like every customer, has a wide range of choice, whether in specialized areas of a department store, in the various kinds of specialty stores, or in other specialized stores.

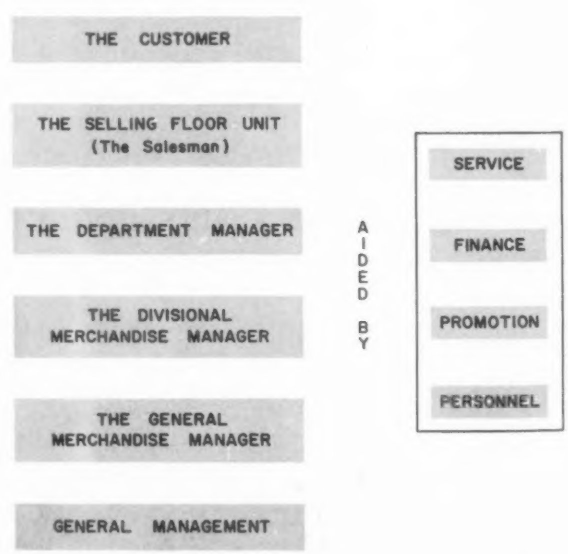
STORES looking for goods to meet customer demand have almost as much choice as their customers. The most elaborate method involves having goods designed to meet a particular need. This is a little more common than many realize. It is standard practice, for example, in many foreign markets, where it is desirable to add American colors and designs to the hand craftsmanship of Europe or the mass production of the Far East. It is also standard practice with private brand goods made to a retailer's specifications.

The big user of a particular manufacturer's product will buy direct from the company that produces the product. Most of the merchandise in a large retail outlet or department store is acquired this way; but the distributor, the wholesaler, and the importer all have an important part in supplying the retail outlet. Even in a big store like Lazarus, with hundreds of merchandisers making market trips every month and season, we buy many lines of goods through wholesalers or importers, rather than from manufacturers.

Here is an interesting example. We have an upstairs budget millinery department and a basement millinery department; both stock hats of approximately the same price and quality. The upstairs department buys one line of hats directly from the manufacturers and gets three to four weeks' delivery. The basement department manager pays a little more for the same manufacturer's hats because she buys through a wholesaler; but she gets three to four *days'* delivery. The basement department manager is convinced that a fast operation, with a slightly higher initial cost, can be more profitable than the three- to four-weeks' delivery operation.

The retailer's function, as we see it, is to represent the consumer in the manufacturer's showrooms or at the wholesale house. (No self-respecting retailer looks upon himself as a representative of a manufacturer.) This representation requires a prejudgment of consumer wants. Because of this, we are organized a little differently from most big companies. We attach priority importance to the selling floor unit, the point at which the merchandise, the retailer's representative (the sales person), and the customer meet, and the point that can be studied by the observant buyer. All successful retail operations are organized in this way. We have simply adopted the organization of the successful one-man store, where one man makes all the decisions and represents the customer.

Some people call ours the "upside down organization chart," but for a customer-oriented business, dependent for its success on customer sensitivity at the selling floor, we consider it "right side up." The organization chart looks something like this:



The functions of service, finance, promotion, and personnel are all "sales supporting functions," operating at each level of the organization chart and helping to sell more goods more profitably.

But the selling floor is our research laboratory. We base our judgments of our future stock contents on the way customers respond to our stocks and by what they ask for that we don't have. Having the right merchandise with the right features at the right time, and presenting it in the way that is most acceptable to most customers are the only reasons we are in business; and in a store like ours, this requires decision-making hourly and daily on the selling floor. Hence, our department manager is given authority to buy and sell within the limits of a prescribed plan that he himself has made out. And he has the responsibility for the profitable development of his area of goods, just as the small retailer has. All other members of the organization, including management, are there to support these department managers' selling units to help make them more effective.

RETAIL planning determines the marketing pattern of the economy to a large degree; the seasonal patterns of retailing are well known to manufacturers, both by type of merchandise and by type of retailer. The appliance manufacturer, for example, gears his production schedules and his national advertising schedules to the June retail peak in refrigerators, to the midsummer dehumidifier business, and to the fall automatic dryer business. But the evolution of the postwar consumer has brought about changes in retail planning that have also brought about changes in manufacturer planning.

One of the most productive retail developments in postwar years has been the acceleration of effort to promote off-season selling. The slow selling period of June and August, and January and February, as well as early November, have been made more profitable by aggressive promotion. Retail pressures have speeded up delivery of new seasonal goods so that spring apparel, for example, makes its welcome appearance in many stores before Christmas. These same pressures have caused manufacturers to maintain production and reorder services on best sellers for longer periods and have required the development of value goods for dull postseasons. It has been our experience that a vigorous attack on preseason and postseason periods does not diminish, in any way, customer response to the in-season periods. In fact, preseason emphasis tends to improve the normal selling periods.

But even more important than the promotional interest is the intense forward planning that is now becoming customary in all kinds of retail stores. As our stocks have grown and as specialized merchandise areas have expanded, it has been necessary to develop careful timing and action calendars in each separate area of merchandise—calendars that signal the types of decisions that have to be made and when they have to be made.



It has been necessary to develop each season's financial plans around well-identified appeals to customers in each area of merchandise. Such features as the "fashion look" and the work-saving materials and designs, as compared to mere utility, sell more goods to more customers. For example, the fitted sheets, the pastel colored sheets, and the lovely printed sheets have taken a large part of the plain white sheet business as the new postwar customer has become more conscious of the fashion look she wants and the work-saving features.

We, as many other retailers, do our merchandise planning around features that attract customers: style, color, material, trim, design, work-saving benefits, special sizes, and value pricings. The brand (the manufacturer's feature) usually becomes secondary in our planning. The well-known quality brand is a great feature too, but only to the extent that it suggests the other features.

The retailer's demands for certain features are relayed to the manufacturer's designing department when we have determined what we want in our stocks three days or three months ahead, depending on the wholesaler's or manufacturer's delivery time. These demands affect what will be manufactured, what is newly developed, and what is promoted at the national marketing levels. It is rare nowadays to find a department manager without a clear idea of exactly what customer features he is shopping for —tempered, of course, by the new features that the manufacturer is showing. He will also know how much he is going to buy of each type, because each is planned to keep his total stock in balance.

In this connection, it is interesting to note that the retailer today doesn't look upon a boys' business, for example, the way he did in prewar days. Such a business today, whether in a specialty store or a department store, is made up of seventeen separate businesses, which we call classifications: boys' underwear, boys' hose, boys' trousers, boys' jackets, boys' suits, boys' dress shirts, boys' sport shirts, and so forth. Each of these is further broken down into size classifications. Each of these businesses is carefully planned, controlled, and watched financially and considered a separate business that must grow on its own. Each of these businesses must be carefully and thoughtfully balanced in terms of high and low price lines, in terms of staple versus fashion merchandise, and in terms of each aspect of its assortment. Even within a classification such as sport shirts there are many separate businesses to be looked at individually, such as long-sleeved shirts, short-sleeved shirts, and plain and fancy shirts. Even within the fancy shirt classification, there are many separate businesses, such as stripes and prints. And so the retailer runs a series of little businesses for the customer, having what she wants, in the way she wants it, and at the time she wants it.

As our economy continues to expand, as the age levels within the economy change, and as the income levels within the economy change, retailing must remain fluid in years to come. Retailing must change the ways in which it offers goods and services to the changing public, because the retailer in the American economy is the consumer's personal representative, a responsibility that carries with it continuing challenges and opportunities.

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# PROMOTION

## INTRODUCTION

Albert W. Frey

The purpose behind any study of the problems of promotion is to make improvements in the content and techniques of marketing available to the marketing manager so that he in turn may make better decisions. While a great deal of empirical data is available in the field of marketing promotion, there is still much to be done, much to know. Our present knowledge of marketing is meager.

Marketing management, for example, needs to find ways and means of making better decisions in the promotion area. Because not enough is known about how promotion decisions should be made, the degree of guesswork employed in this area today is far too great. Marketing men also know too little about how consumers arrive at *their* decisions, and how they will respond to any influence the marketing man may attempt to exert upon them. Basically, then, there is a strong need for better executive decisions made in the light of more extensive and more accurate knowledge of the factors that influence consumers' decisions.

### DEFINITIONS

There may be considerable difference of opinion concerning what is to be included in each of the promotion activities: personal selling, advertising, sales promotion, and publicity. For the purposes of this discussion, the following definitions are used:

*Personal selling* refers to the efforts of salesmen when they call on customers and prospective customers in order to induce purchases.

*Advertising* is the preparation of visual and oral messages and their dissemination through paid media for the purpose of making people aware of and favorably inclined toward a product, brand, service, institution, idea, or point of view.

*Sales promotion* is concerned with the creation, application, and dissemination of ma-

This article and those that follow in the seminar on promotion are summaries prepared by Jean C. Halterman.

terials and techniques that supplement advertising and personal selling. Sales promotion makes use of direct mail, catalogues, house organs, trade shows, sales contests, premiums, samples, window displays, and other dealer aids. Its purpose is to increase the desire of salesmen, distributors, and dealers to sell a certain brand and to make consumers more eager to buy that brand. Personal selling and advertising can go only so far in these decisions; sales promotion provides an extra stimulus.

*Publicity* is like advertising in some respects but differs in that it is used at the discretion of the media to which it is sent, media are not typically paid for using it, there are no established media rates for publicity, and the company or institution by which or for which it is released is often not identified with the message.



In short, personal selling tends to move the product through the distribution channels toward the consumer; advertising tends to move the consumer toward the product; and sales promotion and publicity facilitate both these activities.

The importance of definitions is not confined to placing workable delimitations on discussions of advertising, selling, and sales promotion. In budgeting, particularly, the business executive must be concerned with definitions, with what should be included as advertising, what as sales promotion, and what as publicity and public relations. For purposes of comparison, control, and executive management, then, definitions of the promotion activities must be clearly stated.

### FUNCTIONAL INTEGRATION

Decisions in marketing deal with the ends and means, with strategy and tactics, and with the achievement of the right quantity and quality of each type of marketing effort. Strategy in the promotion area must be in tune with strategies in other areas—such as production and pricing—and the total strategy must consist of a profitable optimum combination of *all* marketing activities.

The offering to consumers is a combination of the product, package, brand, service, and price. This offering is implemented through the tools of promotion—personal selling, advertising, sales promotion, and publicity—and through decisions related to the marketing organization and policies such as decisions concerning distribution channels. Most of the factors in these areas can be controlled, at least in part, by the business firm. Yet the manager must be concerned also with additional factors of the environment, including the market and competition, over which he has no control at least in the short run.

While decisions have to be made concerning organization and policies—whether, for example, to sell to discount houses, or whether to use advertising as a component of the marketing mix—these occur less frequently than decisions in the promotion area. Decisions in this area must be made with regard to three broad categories of specific objectives: company, marketing, and advertising (or other elements of promotion). Within this framework, the basic, though not mutually exclusive, questions concerning the effective use of the promotion tools at reasonable cost are: (1) whether to use the tool (personal selling, advertising, sales promotion, publicity) at all, (2) how much to use it, (3) how to use it (4) how to control its use, and (5) how to measure its effectiveness.

## PERSONAL SELLING AND SALES PROMOTION

AL N. SEARES

MARKETING is "the greatest profession in the world today," and selling—"the art of persuasive communications"—is an especially important adjunct to the distribution process. From the point of view of profitable management, there is an economic responsibility in marketing to speed up the flow of cash in order to bring a more adequate return on investment. Unsold inventory may cost the company from 13 to 33 per cent, and these high costs obviously cut into profit. In

1959, for example, the average annual inventory turnover equalled 6.22 for manufacturers; 10.91 for wholesalers; and 8.33 for retailers. To the extent that the sales function can convert unsold inventory into sold inventory, it can increase these turnover rates and thereby increase profits. Inventory data, incidentally, are not especially significant except as they relate to total movement of merchandise and economic growth.

### SELLING VERSUS MERCHANDISING

In order to implement the selling function, management must have much more complete knowledge of why people buy or do not buy. The relation of buying patterns to buying motivations tends to determine the balance that must be struck between personal selling and other types of merchandising. For certain essential products, like bread, certain kinds of regular, normal buying habits develop; in some instances this buying pattern can best be implemented through "creative merchandising." For other products, however, the consumer must be educated concerning his needs, and in these cases the same kind of buying patterns do not develop. Here, creative selling is needed to move the products in volume to the consumer market.

The roles of merchandising and selling, then, are different. Merchandising must seek to build brand preference, user benefits, and consumer understanding, all of them leading to sales, and these functions must relate closely to problems of cost. Selling, on the other hand, must seek to develop latent needs; it must build comprehension, explain user benefits, and develop understanding, all of them again leading to the ultimate sale in a manner that relates to the value of the "investment" in selling rather than to the ratio of cost to margin.

"People are 'down' on what they are not 'up' on," that is, they do not favor products they don't know. Selling must provide that type of product education that results in favorable attitudes and market motivation. A helpful technique in developing a better understanding of those consumers the sales force hopes to reach is the "problem-assessment seminar." In such meetings, the sales force can interchange ideas about successful appeals, consumer motivation, and user benefits that relate to the needs of the consumers for whom the product is suited.

### THE COMMUNICATIONS MIX

Sales management must provide a suitable balance of the various parts of the communication mix. For example, the balance of such factors as personal selling, point-of-purchase, direct mail, catalogues, displays, technical assistance, and advertising for demand stimulation and product preference varies greatly between consumer goods and industrial goods, and between those consumer products that are expendable and those that are durable.

Furthermore, the ingredients in the communications mix vary depending on the need to produce an awareness for the product, understanding of the message, conviction, and ordering. For certain types of industrial products, efficient advertising builds awareness, but may be less strong than personal selling in closing the sale.

Certainly the techniques of personal selling can be reinforced by appealing to all the senses; for example, a combination of oral and visual presentation can often produce better sales results than the use of a technique aimed toward a single sense. In one tested case, the addition of visual materials to an oral sales presentation increased the possibility of consumers remembering the product by 55 per cent.

### SALES PROMOTION

In many respects, sales promotion activities are as important as advertising. Their role in the whole promotion process depends, of course, on the particular marketing circumstances. Many activities fall within the area of sales promotion, and the field might be described as "those marketing activities, other than advertising, personal selling, and

publicity, that stimulate customer purchasing and dealer cooperation."

Sales promotion activities can affect the the performance of all promotion activities, and the responsibility for a salesman's performance rests ultimately with the sales manager who recruits, selects, trains, supervises, and manages the sales force. Five promotional factors that can help specifically in the performance of the personal selling function are:

1 Develop both internally and externally a strong line of communication with the salesman.
2 Check the motivation value of sales promotion efforts by accompanying the salesman on his calls from time to time. Is the promotional material achieving its objective? Can it be made permanent and more useful to the salesmen? Can the variety of materials furnished to salesmen be classified and indexed so that they are more readily accessible? Can the effectiveness of promotional material be checked with dealers and distributors?
3 Coordinate the advertising message with the selling function. Salesmen should be kept informed about current and proposed advertising campaigns, including information about appeals and sales points that will be stressed in the advertising. Often the salesman can provide useful information about appeals that can be incorporated into the advertising campaign.
4 Particularly in industrial selling, check with satisfied customers, collect testimonial letters, and use these letters as additional sales promotion tools.
5 Impress upon the sales force the value of advertising.

A careful description of the sales manager's position and a personal progress appraisal would provide management, particularly top management, with two useful tools. Experience has shown that various factors commonly contribute to sales failure and others to management success; one check list, for example, prepared by Associates in Management Services-International, lists thirty-two reasons why salesmen fail. Through personal progress appraisals both of management and individual members of the sales force, it is possible to spot patterns of performance early and thus institute training programs designed to correct any weaknesses that may be identified.



## THE ADVERTISING APPROPRIATION

ALBERT W. FREY

TO DETERMINE the number of dollars that should be allocated for advertising and sales promotion is obviously a difficult problem. In this area of marketing, as in others, perthat point is reached where an additional theory. Under the marginal revenue approach, theory would suggest that dollars should be added to the appropriation until that point is reached where an additional dollar will no longer bring additional contributions to net profit. Yet this marginal increment theory is of little practical value in decision-making; the appropriation is not achieved by the addition of a series of single dollar increments.

These major problem areas complicate the appropriation decision:

1 Management can seldom be sure of the results of advertising, and at present has no measure of absolute results before the advertising appears; yet results and appropriation must of necessity be closely tied together.
2 A variety of variables other than advertising affect the results by which advertising is measured.
3 These variables—many of which cannot be controlled—interact so closely that the results of advertising depend on the action of the variables and cannot be clearly separated from them.
4 Short-term results of advertising often cannot be separated from long-term results, although management in some cases disguises its success or lack of success in promotion by hiding behind a long-term objective that cannot be immediately measured.
5 It is difficult to measure certain "indirect" influences of advertising, including the effect of consumer advertising on retail dealers.

### APPROPRIATION METHODS

In spite of these difficult problems, a number of "standard" methods for setting the advertising appropriation are often discussed. These include: (1) arbitrary appropriation; (2) employment of all available funds—particularly useful in the introduction of a new product; (3) competitive parity whereby the budget is set in relation to an average for the industry; (4) percentage of sales, which may be appropriate for a product well

advanced in the life cycle and holding to fairly well-established promotion patterns; (5) fixed sum per unit; and (6) the research-objective method by which the total investment required is determined by totaling the cost of specific advertisements needed to achieve a stated objective. Perhaps, in addition to these, a "marketing program" method might be appropriate and workable. By this method, the advertising manager would have to submit his estimate of monetary requirements for consideration in light of the total marketing program and then defend his budget position before a group of executives responsible for other activities in the marketing program.

Although the percentage of sales method is often the subject of criticism, certain studies would seem to show that there is a reasonably close correlation between share of advertising within a product group and share of market.

Both measurement of advertising and determination of the advertising appropriation must be closely tied to specific objectives. Some attempts have been made to relate advertising to sales or profit objectives, but, for reasons already listed, these objectives are not altogether workable for appropriation and measurement purposes. As a result some firms have attempted to tie evaluation to objectives related to noting, reading, listening, or viewing; these objectives, however, are perhaps too narrow to be of significant value in problems of budgeting.

Since advertising is a means of communication designed in many instances to create an awareness of products and to create a favorable attitude toward those products, it would seem reasonable and sound that problems of measurement and related problems of budgeting might profitably be tied in with these specific advertising functions.

### WHEN TO ADVERTISE

Rather than beginning a discussion of appropriations with questions of "how much," management might profit by starting with the question "should advertising be undertaken?" Does the opportunity exist, in fact, for a profitable use of advertising? If advertising cannot be profitably employed, then the need for budget considerations becomes superfluous. If, however, the profitable opportunity for advertising does appear to exist, as measured against definite criteria, then management can move on to the business of budgeting using the best tools presently available.

A great opportunity exists today in the application of operations research to the determination of the advertising appropriation. Controlled experiments and other applications of scientific methodology to budgeting problems also afford real opportunities for greater insight into problems of advertising decision-making. Operations research, combined with controlled experiments, may help to identify and isolate all the variables affecting sales, lead to a method for assigning reasonable values to each of the variables, and provide a method for working out the best combination of these variables in relation to net profits.

### THE "MICRO" APPROACH

Most approaches to the problems of budgeting have been "macro" approaches, in that the decision has dealt first of all with what total appropriation is required. Perhaps management should take a "micro" point of view and begin the advertising planning with the consumer rather than with the firm. Such an approach requires extensive information about buyer behavior, and unfortunately, management today has only a meager knowledge of this important field.

The "micro" approach requires answers to many perplexing problems related to the consumer: How many advertising impressions does it take to persuade the consumer? How many specific advertisements must be purchased to create the necessary number of impressions? How can management best schedule the required number of advertisements? Additional information is needed related to the "message-basket concept" of coverage, frequency, and continuity.

Yet, with answers in these important areas, management could perhaps determine the number and scheduling of advertisements required to achieve a specific objective, and then could total the media and schedules to arrive at an appropriation figure. Any studies in these areas—or studies combining the "micro" and "macro" approaches—could certainly contribute immensely to the effectiveness of management decision-making in all areas of promotion.

## AN EXAMPLE OF SALES PERSONNEL EVALUATION

Herbert R. Keith
*President, The Service Bureau Corporation*

Next to "why do consumers buy?" the most difficult question facing management is "what makes a good salesman, and why does someone want to become a salesman?" Partly to aid in recruiting, International Business Machines Corporation made a comprehensive study of its 2,000-man data processing sales force in an attempt to answer these questions.



To reflect the actual composition of the data processing sales force as accurately as possible, a "stratified random sampling procedure" was used. Factors of geographic location, age, and sales performance were specified to ensure that the sample would correspond to the distribution of these factors in the total sales force. From this random selection of 200 salesmen, the company found that the typical salesman selected was 30 years of age, was on quota with the company less than three years, and earned $15,900 in 1959.

The individuals making up the sample were interviewed in depth by two-man teams of sales executives and trained social scientists. The sales executive focused on the individual's reaction to his sales experiences and his opinions about various company policies; the psychologist focused on the individual's personal background and motivations. Face-to-face interviews were used instead of questionnaires, in order to probe more deeply and avoid superficial or stereotyped answers.

After the interview, the total sample could be classified into six categeories. The most successful salesmen came from families where the father was dominant, and where the need to be a success was strongly emphasized. Less successful were those men who came from families where friction existed between the son and the father, either because the latter tended to deride his son's plans for the future or because the son sought to surpass the accomplishments of his father. The least successful salesmen came from closely knit families where love, peace, and harmony existed in the family group; among this least successful group were also those who had been "spoiled" children and who were not allowed to face challenge and responsibility in early life.

In general, the successful salesmen were those who made their own decisions—such as what school to attend, what course of study to follow, what career to pursue. These findings indicate that self-determination and leadership qualities are important for sales success. In further support of these findings, these characteristics seem to be lacking in those not judged successful as salesmen.

The tests and interviews suggest that one of the greatest motivating factors in selling is a desire for early recognition in life. On the basis of this conclusion, the company is revising its methods of recruiting, changing certain training aspects, upgrading the caliber of instruction and providing greater specialization for sales personnel, revising compensation methods, and carving out more distinct career paths for sales personnel within the company itself.

## EVALUATION AND BUDGETING OF ADVERTISING

G. Maxwell Ule

Marketing is the profitable creation and satisfaction of consumer demand. The field faces production problems—both in the production of products to satisfy consumer

needs and in the creation of markets to accept those products. It is the role of the marketing decision-maker to implement this broad concept of marketing, but "most men are not qualified to make decisions." Administrators must qualify themselves for decision-making in the marketing area, and decision-making can be aided when management works to develop two abilities: the ability to define a problem and to become oriented toward problem definition; and the willingness to rehearse alternative solutions to problems.

In advertising decision-making, the future may well hinge on what might be called "disciplined creativity." Yet the development of advertising into a discipline will require crossing many difficult hurdles, not the least of which is the reluctance of men to have their performance measured. Further, the values of advertising in the marketing mix must be appraised, and the difficulties inherent in this area are widely known.

For the moment, these problems must be set aside. Advertising is a means of communication, and enough is known today about communication theory for advertising practice and consequently advertising management to be improved by this knowledge. The comments presented here are one way by which a "blend" of this communication point of view with the problems of advertising decision-making might be achieved.

## THE ADVERTISING BUDGET

What is the "correct" advertising budget? Perhaps there is no correct answer to this question from management's point of view, although there can be a reasonable and defensible answer. The correct budget depends on marketing objectives; if those objectives are clearly known, then management can begin to state what the advertising problem will be. Is the objective to maintain sales volume? To increase volume? To maintain profit levels? To increase those levels? To introduce a new product? The specific objective will most surely affect budget considerations, and will also affect the results obtained from dollars invested in advertising. For example, the incremental costs required to increase sales from one level to a higher one may be greater than the incremental cost of advertising designed to maintain present sales.

Two broad approaches to the problems of the advertising budget might be used: a "bookkeeping" approach, or a "marketing" approach. The bookkeeping approach to problem solving, however, would not take into account the productivity of advertising or the relationship of incremental costs to results. For this reason, perhaps an approach tied to the marketing objective of the firm would provide a sounder basis for decision-making. This marketing approach must begin with a clear understanding of the role of advertising in helping to meet various marketing objectives.

## THE ROLE OF ADVERTISING



Many elements combine to affect the sale of a given product in the market place: the product itself, package, price, sales force, distribution, shelf facings, merchandising, promotion, trade incentives, competitive countermeasures, product image, and advertising. One element alone cannot normally achieve the optimum sales objective of the firm. Thus a major problem facing management is to determine the amount of emphasis that should be placed on each element. In a sense, these market elements are a symphony, and the marketing manager is director of the symphony.

In this mix, advertising seeks to accomplish two broad objectives, one designed to help the consumer decide what to buy, the other designed to explain to the consumer why to buy. These two objectives are: (1) to build and maintain product awareness at the consumer level, (2) to build and maintain favorable consumer attitudes toward the product.

These two functions constitute the role of advertising. Many critical advertising de-

cisions may be based on the knowledge that advertising's only role consists of building awareness and favorable attitudes.

### ATTITUDE AND AWARENESS

The phrase product awareness describes the degree of saliency that a certain brand has in the consumer's mind. The measurement of product awareness indicates the degree to which a brand name enters the consumer's consciousness upon stimulus. For example, a consumer might be asked to "name as many brands as you can of laundry soap products," and the responses could be tabulated to show the relative awareness of the variety of brands mentioned.

Consumer attitudes represent the degree of favorable emotional impression that a consumer has of a given product. Consumers might be asked, "How well do you like this specific brand of a product?" In answer, the consumer would rate the product on a scale that might range from —5 through 0 (or neutral) to +5. By totaling responses from a group of consumers, it is possible to rate consumer attitudes toward a variety of competing products. This rating is impersonal; it does not require the respondent to explain the reasons behind his attitude, and, as a result, reflects both the conscious and subconscious motivations that help to form consumer attitudes toward various brands.

The two measures—product awareness and consumer attitude—can then be combined numerically to provide ratings for each of the products of which the consumer respondents are aware.

Specific, intensive tests have shown that the combined rating of attitude and awareness has a positive correlation with sales, and that both the favorable attitude and the high degree of product awareness must be present before a large volume of sales is achieved. These tests also show that a point of diminishing returns exists: Sooner or later, input designed to build more favorable attitude and awareness scores brings the desired output at higher and higher cost. This point of diminishing returns can be determined and plotted for specific products.



### MEASUREMENT ADVANTAGES

Attitude and awareness measurements provide certain advantages in the evaluation of advertising and in the management of advertising activities. First, these measures are closely related to sales objectives, as opposed to measures like viewing, which may not correlate closely with sales. Second, attitude and awareness factors are independent of most nonadvertising promotion factors, and the effects of specific advertising activities on attitude and awareness can be rather clearly isolated. Third, the factors can be measured relatively easily and more rapidly than sales. Furthermore, attitude and awareness measurements can be used to predict sales, and can be related to advertising input and output. For these reasons, the measurement of these factors reduces the area for judgment by management and thus can improve the effectiveness of management decisions.

### APPLICATIONS TO ADVERTISING

Three elements of the advertising program relate to factors of attitude and consumer awareness. These factors are: (1) what is said in the advertisement, or content; (2) how it is said in terms of appeal, use of color, media, and so on; and (3) how much is said, both in terms of total number of advertising insertions and number of impressions made on prospects. The last two factors relate specifically to problems of the advertising budget.

In connection with attitudes, there should be a strong correlation between consumer's belief in the advertising message and his attitude toward the product. When an appeal is selected and tested, that appeal may be judged weak if the correlation between belief and attitude is not strong; when the correlation between two factors of belief and attitude is high, then the appeal in relation to its effect on attitude and awareness should be strong. As belief in a specific advertisement increases, favorable attitude toward the product should also increase.

Thus it is possible to select the best of several possible appeals for specific advertisements through tests that correlate belief with attitude.

Further, the effect on attitude and awareness can be measured in terms of exposure to a single advertisement, making possible a pre-evaluation of appeals, layout, color, and other advertising techniques. In controlled experiments, consumer attitude and awareness among the group can be measured; after exposure to a single advertisement, the attitude and awareness factors can again be measured, and in terms of attitude change (or gain) the specific advertisement can be evaluated.

### APPLICATION TO BUDGETING

So far, the steps described have suggested ways by which the effect of an individual advertisement on attitude and awareness can be measured. To solve the problem of how much should be invested in advertising, it is necessary to determine the number of exposures to the advertising message— or "conscious impressions" — required to achieve that level of attitude and awareness needed to accomplish a specific sales objective. Media evaluations can then be made on the basis of their ability to deliver measurable numbers of conscious advertising impressions.

Suppose, for example, a manufacturer of packaged goods sets a sales objective of $15 million, or 10 per cent share of the market. It is possible, through the steps described, to determine the level of attitude and awareness that must be generated in order to reach this objective. The advertiser may find that he must reach 70 per cent of all households with at least one conscious advertising impression in order to raise the attitude and awareness score sufficiently to generate the $15 million sales objective. In terms of marginal cost, the studies may show that impressions beyond 70 per cent of the households may have higher costs than can be justified in terms of results. Thus, in terms of coverage, conscious impressions tend to follow a cost curve of diminishing returns.

A single conscious impression may not be enough to build the required brand awareness; therefore the advertiser must also develop sufficient frequency of impression to build a brand awareness that is comparable to the attitude levels held by major competitive brands. In general, awareness tends to increase as frequency of conscious impressions increases.

Tests for this particular type of packaged goods show that, on the average, a 3 per cent share of attitude and awareness is roughly equal to a 1 per cent share of brand use. Thus, if a brand could achieve a favorable attitude and awareness score among 6 per cent of the consumer group, that brand should achieve a 2 per cent share of the market, and the company seeking a 10 per cent share of the market would need to achieve a 30 per cent degree of awareness. This relationship of attitude and awareness to share of the market generally holds true up to a point of diminishing returns.

Studies in this field also indicate that, as a general rule, one conscious impression should produce 2 per cent brand awareness. The packaged goods company that wishes to achieve 30 per cent awareness would need 15 conscious impressions. As shown earlier, the media schedule cannot efficiently cover 100 per cent of the market; marginal costs limit coverage to about 70 per cent. Given this coverage, the media schedule would require 21 advertising insertions to equal the 15 conscious impressions required to achieve a 30 per cent degree of awareness. By computing cost per thousand for reaching 70 per cent of the market with 21 insertions, the advertiser can then determine the dollar requirements for a campaign designed to achieve the sales objective of $15 million, or 10 per cent share of the market.

The cost of adding to an existing share of the market may be much higher, perhaps as much as double the cost of maintaining a present share of the market. Much the same problems exist when introducing a new brand into a relatively mature market.

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# PRICING

## PRICING—AN AREA OF INCREASING IMPORTANCE

CHARLES M. HEWITT

SOME YEARS ago, Joel Dean commented that, although pricing is of central importance to economic theory, most American business executives felt that it was their least important worry. There are many reasons why pricing decisions have demanded a larger share of executive attention in recent years.

Overcapacity, increased competition from foreign-made goods, higher labor costs, automation, and certain recent demographic trends have contributed to both overproduction and a tendency towards sharply increased price competition in many industries. Evidence of the impact of these competitive pressures on the marketing levels of various industries shows in trends toward scrambled merchandising and the use of nontraditional distribution channels, the decline of fair trade, and diverse attempts by manufacturers to obtain controlled distribution. On the other hand, nonprice competition, with a growing stress on product and promotion policies, seems to be the basic competitive strategy in European markets. For the present, at least, European markets appear to be growing fast enough to absorb the increasing supply of goods. There are signs, however, that competitive pricing may be on the increase in many European countries.

Paradoxically, this purported lack of executive interest in pricing can be rationalized either as evidence of rigorous competition or as evidence of some form of monopolistic power or collusion among competitors. Under highly competitive conditions, the entrepreneur has little choice as to the price he may charge if he is to sell his goods. His crucial decisions are cost decisions rather than price decisions. Likewise, under conditions of mo-

nopoly or collusion the cooperating firms will usually pay little attention to prices once they are set. The tendency is for such prices to remain stable until fresh circumstances warrant a reappraisal. In an industry dominated by a few large firms selling fairly similar products, prices tend to be uniform and stable even though there is no collusion among competitors. Each firm soon realizes that price cuts will be promptly met by competitors, and that all stand to lose unless the demand and/or cost situation in the industry is unusual.

Most firms have some—but not unlimited—discretion as to the prices that they can charge. However, primarily because a few firms apparently do have a considerable range of discretion over their prices, controversy has arisen over whether businessmen should consider social objectives as well as profit objectives in setting their management policies.

Writers who argue that businessmen must assume more social responsibility reason that the firms with the discretionary power over prices must exercise restraint if an inequitable allocation of national resources is to be avoided. Some critics of this social responsibility thesis assert the over-all effectiveness of competition and deny the existence of substantial discretionary economic power. Other critics make the alternative argument that some monopolistic price stabilization power is essential to encourage investment and innovations. The innovation process, rather than price competition, is viewed as the real mainspring of lower prices and better goods to consumers.

Still other critics of the social responsibility thesis argue that the free enterprise system cannot function efficiently unless there are effective competitive market checks on the extent of private economic power that might be wielded by entrepreneurs. These critics reason that substantial discretionary economic power must be curtailed either through vigorous antitrust action designed to invigorate competitive forces or through various forms of government surveillance or regulation. These critics tend to mistrust various social concepts that portray business managers as "trustees" of the public interest. They particularly dislike the "baronial" or *noblesse oblige* aspects of these concepts.

## CONCEPTUAL APPROACHES

### *Cost-Oriented Approach*

It has been suggested that there are three basic approaches to pricing.[1] A discussion of these approaches serves to demonstrate some of the complexities involved. Various studies indicate that cost-oriented pricing practices find widespread use in both the manufacturing and the marketing sectors of industry. Typically, a forecast of sales is made, followed by an estimate of total unit cost at some standard or expected operating rate. To this basic cost figure is added a percentage markup as profit. It will be noted at the outset that this method involves circularity of reasoning. In estimating the standard operating rate, an estimate of price must be used; the operating rate selected sets the costs, which, in turn, establish the price.

### *Economists' Approach*

Cost-plus pricing practices are criticized by economists on many grounds. Under conditions of competition, economic theory predicts that unit prices will tend, in the long run, to be equal to total average unit costs (including a normal profit). But no necessary relationship exists between price and costs in either the short run or market (inventory) period.

A good part of the criticism of cost-plus pricing is directed against accounting practices. Economists argue that the accounting costs utilized in cost-plus pricing are theoretically and factually unsound. Accounting costs do not allow for many implicit or opportunity costs and do not properly handle such items as depreciation reserves, divi-

[1]This discussion is an elaboration of some ideas presented by Professor Alfred R. Oxenfeldt of Columbia.

dends on preferred stock, and capital gains and losses. More important, the economists argue that accounting costs involve the use of historical averages, while current pricing decisions should be based on present alternative-use values and marginal analysis. For pricing, the manager should compute the added cost for the last unit (or batch of units) to be produced, and the price should be set where the added cost will be equal to the added revenue generated. In some situations, this marginal cost may exceed the average cost as computed by the accountant —in others, it may be less.

In addition, the economists charge that accounting costs frequently include irrelevant "sunk" costs and that pure cost-plus pricing does not give due regard to conditions of demand. As was stated previously, if profits are to be maximized, the price must be set at the point where the marginal costs of producing and selling just equal marginal revenue generated. While theoretically sound, the marginal approach to pricing offers many practical difficulties. This is particularly true for the typical multiproduct firms. It is extremely difficult to estimate the marginal costs for specific products under such circumstances. Various studies indicate that businessmen do not think in marginal terms when setting prices.



Perhaps the major contributions of the economist to pricing practice have been in the area of demand analysis. Various concepts of elasticity and cross-elasticity of demand have been of significant value to marketing research and to practical decision-making. Even a highly simplified linear demand-schedule concept helps to clarify thinking as to the relevant factors that may determine the slope (elasticity) and position (magnitude) of the demand for a firm's products.

More sophisticated demand concepts involving game theory, and additional elements of realism are in the process of development. The ultimate success of approaches of this type will hinge on the degree to which the key considerations affecting pricing decisions can be quantified.

*Marketing Managers' Approach*

The marketing manager should recognize that the theoretical arguments of the economists—granted their premises—are sound. At the same time, the marketing manager should recognize that in many, if not most, real-life situations the premises are unrealistic and that, of all marketing decisions, pricing decisions are the ones most often involved with problems that concern delicate and unpredictable human relations. It should be recognized that, as a topic for study, pricing should be handled by the behavioral sciences.

Consider for a moment the parties having a more or less direct interest in the pricing policies of a firm. First, within the firm, the price set usually represents a compromise. The finance department recommends one price, the marketing department another. The actual price is nearly always a result of an interplay of power politics within the firm.

Second, customers play an important part in a price decision. How will they react to various prices? Huge sums of money have been spent in researching customer motivations and attitudes in regard to advertising, packaging, and promotion; but amazingly little has been done in regard to the psychology of alternative pricing policies and strategies.

Third, middlemen are parties directly affected by pricing decisions. The price that might maximize profits for the firm might cause huge losses in money and morale among dealers and distributors. Computing the long-run costs under such circumstances frequently involves "guesstimating" in a type of political theory of games situation.

Fourth, the reaction of competitors is often the crucial consideration imposing practical limitations on pricing alternatives. Winning your competitor's customers with salesmanship or superior products is one thing; attempting to win his customers with price cuts is quite another.

Fifth, potential competitors as well as

present competitors must be considered in setting prices. One writer[2] has suggested the following considerations for the purpose of setting price with potential competition:

1 How easy and cheap it is to get into the business, that is, the height and importance of barriers to entry

2 How much potential competitors know about the profitability of the present producers of the product

3 Whether product acceptance has developed to the point where the "specialty" is maturing into a "commodity"

4 Whether the other aspects of merchandising competition make the producer an easy mark for an invasion

5 Whether the buyers are numerous, highly concentrated, and technically well informed

6 The demands of the firm's suppliers (including suppliers of labor) are frequently influenced by the prices set by the firm.

In addition, the government must be considered as a party particularly interested in pricing. It is doubtful that some of our larger firms would be hailed before the antitrust authorities if they were to adhere strictly to the marginal cost optimum price policies advocated by economists.

The foregoing gives some indication of why a relatively simple concept like the marginal pricing concept suggested by economists can be no more than a starting point for setting prices. How then can the marketing manager set prices? The answer seems to be that he may have to use all of the concepts discussed plus those that he can develop which may have a special significance for his particular situation.

Professor Oxenfeldt has suggested a multistage approach to pricing designed to narrow the range of alternative prices at each successive stage.[3] The stages are as follows: selecting marketing targets; choosing a brand "image"; composing a marketing mix; selecting a pricing policy; determining a pricing strategy; and arriving at a specific price.

It is observed that these steps call for considerably more information than that normally utilized by economists. Markets, for example, are not viewed as homogeneous masses of people but as specific individuals or peer groups, which should be identified and served in particular ways.[4] While a brand "image" is in part a reflection of price, no simple price-quantity sold relationship is assumed.

In summary, the marketing manager understands that the selection of a pricing policy involves a consideration of the interest of all of the parties previously identified and may involve setting price by a process of eliminating alternatives. He properly views pricing as only one element of his marketing mix and utilizes market research not only to set prices, but also as a means of keeping past policies under periodic review.

The atomic age portends tremendous gains in productivity and an increasing variety of competing goods and services. There are also signs that international and domestic barriers to free competition may be breaking down. Education, advertising, and increasing amounts of discretionary spending power will mean better-informed and more selective consumers. It seems reasonable to assume that there will be a gradual reduction in the amplitude and duration of the cyclical swings that have periodically afflicted industrial nations. A public policy based on free competition has the best chance for survival in an environment of steady economic growth.

All of these factors indicate that pricing may become an increasingly important element in the marketing mix. In the world of tomorrow, increased competition may decrease the range of discretion in pricing, but the opportunities for error will still remain.

[2]Joel Dean, "Pricing Policies," in Fiske and Beckett, eds., *Industrial Accountants' Handbook* (New York: Prentice-Hall, Inc., 1954), p. 608.

[3]Alfred R. Oxenfeldt, "Multi-Stage Approach to Pricing" *Harvard Business Review* (July-Aug., 1960), p. 125.

[4]John A. Howard, *Marketing Management* (Homewood: Richard D. Irwin, Inc., 1957), p. 92.

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# EXPORT MARKETING

## SUMMARY

Robert J. Holloway and
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The concepts of marketing management as we know them are as germane to international marketing as they are to domestic marketing. In either case, decisions have to be taken with respect to organization, pricing, distribution, product, and promotion. Market targets have to be identified and measured. Forecasts have to be developed and quotas set. Sales personnel have to be recruited, trained, motivated, and appraised. In fact, if we were to draw up a set of "super" job-descriptions we would find that the domestic marketing manager and the international marketing manager have a great deal in common. On the other hand, it would be a mistake to consider the jobs identical. Many firms do just this. Either because they feel that international markets are not worth the bother or because they believe the differences to be negligible, they confine their creative analysis and basic marketing thinking to domestic problems and "dump" the results—be they products, advertising campaigns, or new marketing strategies or policies—into the international operation in the hope that some sort of "fit" can be made.

As the briefest survey of the literature suggests, academic attention to this area is equally inadequate. Even the course offerings are either warmed-over versions of traditional marketing management offerings or pedestrian treatments of the mechanics of export procedure. At best, they are sophisticated check lists of "Twenty Items to Consider in Selling in Ruritania"; at worst, they list the steps for looking up a foreign freight forwarder in the "yellow pages." If anything, the practitioners are ahead of the academi-

cians. Neither practice nor theory, however, has even begun to sense the dimensions of the problems and opportunities in international marketing management.

As we move closer to Wendell Willkie's "one-world" concept, it is perhaps appropriate to hope that we will begin to see an increasing interest in an evolution of international marketing thought and practice such as we have seen on the domestic level. The requirements of Western political and economic cohesion in the face of an extended cold war underscore the importance of closer marketing ties. Improved communications, the development of various kinds of common markets, and the breaking down of the language barrier and cultural differences, as well as the nascent spirit of international cooperation, all provide new opportunities for the development of mutually profitable international markets on a much enlarged scale. The principal bottleneck is the primitive state of international marketing thought. Clearly, much needs to be done.

As a start in this direction, the participants at the First International Seminar on Marketing Management spent some time discussing marketing management as it applies to the international sphere. The informal discussion covered a variety of topics relating to this field.

### COMPANY ATTITUDE

It is insufficient to state simply that each firm should develop and make known its philosophy toward the export market. Many would argue that companies dabble in exporting and that they should instead stake out a real claim. As Ralph J. Cordiner of General Electric Company has stated, "The timid, half-hearted commitment will never become a significant source of profit."[1] Others might point out that such a commitment can come only after a good deal of experience in the foreign market.

Though a company attitude may not be written out, it may be apparent to all concerned that the company does in fact place a good deal of emphasis on its international operations. Probably the Europeans are less aware of the need for such a policy; many are exporting to neighboring countries almost as we ship from one state to another or, more appropriately, as we ship to Canada and Mexico. Nevertheless, most firms would undoubtedly benefit from a careful appraisal of their positions in international operations and from the development of a company policy that would pursue the goals set forth by management.

### DECISION TO EXPORT

It was recognized that not every company belongs in the export business. One participant cited a small firm in Indiana as an example of this point: This firm was busily engaged in exporting while a large unexploited local market existed for its product. The many advantages of operating in a local market would seem to suggest that domestic opportunities be examined first. Several years ago, a large U.S. construction firm hired a research organization to examine the domestic market; this decision came after many years of foreign contracting work.

It is clear that not every product has an equal chance of being successful in the international market place. Any firm should lead from strength, and it follows that the decision to export a particular product should be made with the same care that a domestic decision receives.

### RESEARCHING THE PRODUCT

The participants at the seminar made a number of observations about marketing research in international marketing. First of all, it is apparent that sources of information are well known. Demographic data, for example, are used by most of the researchers.

[1]Ralph J. Cordiner, "Managerial Strategy for International Business," speech before World Trade Dinner, New York City, Nov. 16, 1960, p. 3.

United Nations material is also well received by those in exporting. It was, of course, agreed that high-quality marketing research is essential to a firm's successful entry into overseas markets.[2]

One fact about research has been proved: It is that marketing research does not always indicate, as some fear, that the market is too small to enter. One example was given of a U.S. food product that was received most unenthusiastically by the firm's overseas managers. Research indicated, however, that persons of a certain income class bought the product in the United States and that this class was sizable in the countries under consideration. The home office, in effect, dictated the foreign marketing program. The results, moreover, have been most satisfying.

Some of the weaknesses of research were pointed out. Most of the participants agreed that basic statistics are not adequate; often the trouble lies with the way in which the data are broken down while, in other cases, there is a lack of data of any kind. The selection of test markets bothered several firms. The lack of experience combined with the lack of data makes test marketing a rather hazardous procedure.



It was agreed that the greatest single weakness of research data was at the consumer level. Certain statistics on income, population, and residence may be available but information on brand loyalty, buying habits, motivation, and so forth is missing. This kind of research is costly for the medium-sized or small firms and, as a result, there is a serious lack in this generai area.

Two participants in the seminar pointed out that their governments (Portugal and Ireland) conducted marketing research at the request of the individual firm. Research results would be given to the firm requesting them before being released to the industry as a whole. Reasonable satisfaction with this device for encouraging foreign trade was expressed by those who had used the service. There are, of course, conditions that would preclude a firm from requesting the aid—for example, those cases involving the collection of confidential material.

[2]See, for example, *Market Research in International Operations* (Report No. 53; New York: American Management Association, 1960).

### ADAPTING THE PRODUCT

Many firms have ignored the obvious fact that a domestic product may have to be changed in order for it to be accepted in foreign markets. Sometimes these adaptations are minor, but at other times a firm finds itself specifically designing a product for the export trade. A number of examples were given where adaptation to a foreign market was necessary. Shoes from Ireland had to be modified before they could gain U.S. acceptance. A health product had to substitute a citrus flavor for a butterscotch flavor in Great Britain. An engine manufacturer built a special small-sized model for the Latin American market.

Adaptation comes at various times in the marketing cycle. At one extreme, it comes only after unsuccessful attempts to market the standard product in a foreign market. Actual trial indicates the need for a modified product. In some instances, adaptation comes after the results of marketing research (including test marketing) suggest that a change will be necessary in order to gain consumer acceptance. At the other extreme, the exporting company designs the product with the international markets in mind. While the third system may be ideal from the standpoint of the marketing concept, it is not the common method. Perhaps, as firms become more international conscious, they will think in terms of the foreign markets before they work on their designs.

### PROMOTION

The purpose of promotion abroad is, of course, about the same as promotion domestically. Very little was offered on this topic except for the usual cautions about language

differences and the necessity of understanding the market. Obviously, media differences and limitations are also critical here.

### PRICING

Lack of time prevented a thorough discussion of pricing the product in international markets. Several observers stressed the differences in standards of living, which play an important part in foreign trade. To buy, people must have money. One nation is decidedly different from another in this respect, so the exporting company must have a good idea of income levels and distributions of income within the potential importing countries. The exporting firm can handle the pricing decision, or it can permit the distributors of the product to price the product for him. This is determined partly by the choice of organization; for example, an integrated international marketing company would have more control over prices than a firm that exports through middlemen in both countries.

Also one is cautioned not to assume that the price elasticities of products are similar in different countries. Clearly, mass markets do not exist for many products in the low-income countries. Hence, the blind application of a domestic pricing strategy, which was designed to develop a mass market, may in fact be a needless waste of revenue. In many international markets, a price decrease would have little impact on consumption.

### MARKET AREA

Several persons gave examples suggesting that international markets should be developed a few at a time. In one case, the firm plans to have sixty-seven foreign markets by June, 1961, although at the present time there are only forty-eight. One market or one group of markets is developed at a time, which amounts to "feeling the way." For a number of concerns, the European market is considered as one market decision. For others, the Common Market countries might be considered as one market decision.

The decision to enter a given market should depend upon marketing research and upon the judgment of those close at hand. Again the decision rests partly upon the kind of organization and the kind of control the exporting company has over its foreign operations. The probable acceptance of the product in a foreign market must be tied to a marketing program, including channels, promotion, and so forth.

### ORGANIZATION

The seminar participants placed a good deal of emphasis on organizational matters. In the first place, the firm that decides to export has a number of alternatives as far as organization is concerned.[3] There are various ways to organize the domestic firm; they range from the separate international company down to the company that handles exports through its regular sales division. Middlemen can be used in either the exporting country or in the importing country, or both.



Plants may be built abroad in some instances. Licensing arrangements may be worked out in other cases. Distributors might be signed on, or a partnership arrangement could be worked out with an indigenous firm. No set rule can be given. The decision must depend upon the company's capabilities, the product, the importing country's marketing structure, and other factors. It became clear that a company may use several systems for the same product. Many of the marketing decisions that have to be made are closely associated with the choice of organization at home and abroad.

As a part of the organizational question, the matter of personnel was discussed. Opin-

[3]An analysis of the organizations of thirty companies involved in international operations has been prepared by the American Management Association. See Alexander O. Stanley, *Organizing for International Operations* (Research Study No. 41; New York: American Management Association, 1960).

ions were expressed concerning the advisability of using nationals in as many management positions as possible. Some persons indicated that this was desirable in some countries but impossible in others. Undoubtedly, this firm had reflected on the differences between marketing systems (and marketing people) in the various countries. Robert Sproul, Jr. recently concluded that financing and local know-how are the two most compelling reasons for using local partners.[4] Also, acceptance of the foreign firm may be greater when nationals are used.

Perhaps there is another aspect of this problem that deserves mention. The firm located in an advanced industrial society has certain social obligations in the country to which it is exporting. If this nation is a relatively undeveloped nation, the exporting firm can render a real service by developing marketing managers in those economies.



A FIRM must be aware of many other considerations if it is going to successfully develop international markets. The attitudes of the governments concerned can encourage or discourage the venture. There are many legal aspects that have to be examined thoroughly prior to licensing, franchising, or reporting of profit and transferring of assets. There is the matter of institutional arrangements within the potential markets. Firms, including manufacturers as well as marketing organizations, vary as to size and capabilities from country to country.

Participants did not seem to feel that marketing management in international operations differed basically from marketing management in domestic operations, but they were very much aware of the need to apply the best principles of management when entering the international marketing arena. It is essential to understand each new market and to adapt specifically to it. It is important, too, to maintain flexibility in the marketing decisions that must be made. The meaning of different standards of living, different brand preferences, different consumer behavior, and different business practices must be appreciated. Then, satisfactory working relationships with the other departments in the firm must be worked out, so that the production department, for example, does not make too many of the international marketing decisions. Finally, there is a pressing need for accurate information and for quality marketing decisions made on the basis of this information and in terms of carefully defined standards.

Failures in international marketing do not occur because marketing management principles do not apply, but rather because the principles have not been specifically adapted to the international scene. Success stories always reflect good marketing management at the international level.

[4]Robert G. Sproul, Jr., "Developing Profitable Partnerships in Overseas Operations," *The Management Review*, XLIX (Oct. 1960), 8.

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# INDUSTRIAL MARKETING

## THE TECHNOLOGICAL REVOLUTION AND INDUSTRIAL MARKETING

ROSS M. CUNNINGHAM

INDUSTRIAL marketing embraces the whole range of products and services sold to industrial, institutional, and goverment users, and involves an estimated $175 billion annually. Several unique characteristics set it apart from consumer marketing. First, trained specialists, members of a skilled purchasing unit, purchase equipment, materials, and supplies for their companies. Purchasing departments have authority over the purchase of standard types of products and represent an important element and coordinating influence in the purchase of nonstandard items. Rational motives rule to a far greater extent than in consumer purchases.

A second distinguishing characteristic is the influence of groups other than the purchasing department. Production, research and development, general management, sales, and other groups often have a voice in the purchase of particular products. This means that the seller must not only know what groups are involved but must be able to communicate with them in language that they will understand.

Third, the precise adjustment of product characteristics to buyers' needs prevails in the industrial market to an extent not found in the consumer market. Needs of buyers even in the same industry are not identical, and heterogeneity rather than homogeneity prevails. In the fourth place, many industrial products have a highly technical nature, and skilled technical service is needed before, during, and after sale. To some extent, this can be provided by the sales force of the seller, supplemented by specialists on call from the regional or home office.

Fifth, a far greater degree of market segmentation exists in the industrial market than in most consumer markets. This leads to great complexity in planning sales and advertising efforts, and to a continuous pressure on marketing costs. Finally, demand for industrial products is derived from the demand for the products manufactured by customers. For example, sale of steel to automobile producers depends upon the rate of production of automobiles. In other instances, the product may be an industrial good, but the same dependence upon its production and sale prevails.

These various differences generate a spectrum of marketing strategies that varies significantly from that found in consumer marketing.

### TECHNOLOGICAL REVOLUTION



Underlying the whole technological revolution, which has been in process during the past ten to fifteen years, are large expenditures for research and development. Although it is difficult to get current actual figures, the National Science Foundation projected a combined research expenditure by business and government of $12.4 billion for the fiscal year 1959-60, or more than double the total amount of $5.1 billion six years earlier in 1953-54.[1] Over this six-year period, about 75 per cent of the funds used for research were expended by industry, 15 per cent by government, and 10 per cent by universities. As might be expected, government agencies were the most important source of funds, contributing 61 per cent in 1957-58. However, in that year industry invested out of its own funds 37 per cent of the total amount, or $3.6 billion, an increase of 63 per cent over its investment in 1953-54.

It is reasonable to suppose that these investments in research and development, already substantial, will increase in the years ahead. More and more new products and processes with increased rates of change and obsolescence will result from this activity. Coupled with this will be increased technical content in the manufacture, sale, and applications of these products.

Mechanization and automation of production is increasing rapidly. This action is prompted by the desire to improve competitive position, not only as related to United States competition, but also to competition from foreign producers. There have been vast improvements in computers and other data processing equipment and methods that permit extremely comprehensive and up-to-the-minute information flow on all aspects of business operations.

Finally, better tools for management decision-making, based both upon the physical sciences and the social sciences, are becoming increasingly available. Mathematical and statistical techniques have proved very powerful as decision aids when properly applied. There is a growing tendency to consider parts of the operation of a business and, at times, the entire business as an operating system. This has yielded important benefits especially in the transportation and inventory control areas. Some work of this nature has also been undertaken in the fields of selling and advertising.

Fundamental research is being undertaken at MIT and elsewhere on the development of complex dynamic models that can simulate business systems when run on a computer.[2] Such models offer better understanding of business and marketing systems, and eventually may be developed to the point at which experimentation can take place on the model rather than in the market. The marketing group at MIT has been engaged for the past two and one-half years in a program of research using dynamic models for marketing systems.[3] This research program has

[1] National Science Foundation, *Reviews of Data on Research and Development*, No. 16 (December, 1959).

[2] J. W. Forrester, "Industrial Dynamics, A Major Break-Through for Decision-Makers," *Harvard Business Review*, XXXVI (July-Aug., 1958), 37-66.

[3] Arnold E. Amstutz and Gerald B. Tallman, "Dynamic Simulation Applied to Marketing," *Marketing Keys to Profits in the 1960's*. American Marketing Association, 1960 (Proceedings of the 42nd National Conference), pp. 78-95.

been helpful in developing an unusually realistic marketing game that is being tested as a teaching device during the current year.[4]

### IMPACT ON MARKETING

With more and more new products and processes becoming available, and many of them having a higher technical content, competition will grow steadily keener, especially in cases where the same function may be performed by several different types of products. There will be an increasing need on the part of customers and prospects for technical knowledge concerning products and their applications. Taken together, these factors will require a definite increase in specialization of marketing efforts by products and/or markets for the industrial sales force, advertising and sales promotion, and types of distributors. Such specialization, although needed to do a more effective marketing job, will be accompanied by higher costs, because fewer product lines can be handled per unit of personnel. Increases in sales volume may provide a temporary escape in some situations, but management will have to institute tighter cost controls.

The increased complexity and faster pace of industrial marketing will require better marketing intelligence systems. Conceptually, these must be heavily oriented to the future because of the long lead times in product and market development. Assessment of technical trends generally and of the technical capacities of present and future competitors will be of extreme importance. Marketing research departments have contributed much to industrial marketing, but they will have to take on a broader portfolio and sharpen their skills if they are to discharge their true responsibilities.[5]

Marketing planning will emerge as a means by which management will be able to cope with increased complexity and ensure the integration of marketing with the total operations of the business. The growing acceptance of marketing planning activity is also based on the recognition that planning must be built into the organization structure if it is not to be shortchanged because of the pressures of day-to-day crises. Such planning will be no better than the facts on which it is founded; therefore, the marketing intelligence function must be of high quality.

Increased mechanization and automation require industrial marketing suppliers to maintain tight quality control in order to meet the narrower specification tolerances usually found in automated plants. Marketing must have more intimate knowledge of customer needs and of the flexibility in product variation and production to meet these special needs. There must be tight control over the production and physical distribution systems in order to provide the exact products ordered at the times and in the quantities specified. The supplier has become, in effect, part of the total system of the customer, and the failure to meet schedules can be extremely serious.

Companies with automated plants are affected in specific ways. Their higher capital investments in specialized equipment mean that forecasts of demand must be as accurate as possible to avoid serious miscalculations. Second, automation can provide low unit cost, provided product variation is limited and runs are of substantial quantity. These conditions are directly contradictory to the concept of more market segmentation and more heterogeneity of demand. Thus, it seems certain that heavily automated companies will be seeking as much flexibility as possible within the constraints of automation, if they are not to be at a disadvantage in supplying an industrial market that is asking for more rather than less product variation

Since the technological revolution is world

[4]Peter S. King, William F. Massy, Arnold E. Amstutz, and Gerald B. Tallman, "The M.I.T. Marketing Game," in *Marketing: A Maturing Discipline,* American Marketing Association (Proceedings of the Winter Conference), St. Louis, 1960.

[5]For an interesting discussion of the marketing information problem, see Marion Harper, Jr., "A New Profession to Aid Marketing Management," *Journal of Marketing,* XXV (Jan., 1961), 1-6.

wide in scope, U.S. companies are operating more and more in a world market, in contrast to the former dichotomy of domestic sales versus export sales. This world-market point of view is coming to pervade the marketing thinking of better-managed companies. It relates not only to questions of what markets will be developed and at what speeds, but to such matters as location of production and warehouse facilities throughout the world.

The use of mathematical and statistical methods has already had a profound effect in the transportation and inventory management policies of progressive companies. Companies that do not make concerted efforts to streamline their physical distribution operation are going to find themselves in an increasingly unfavorable competitive position.[6] Alert managements are also showing more and more interest in applying these newer types of management decision aids to advertising, sales, and other aspects of the marketing program. Some of the larger companies are undertaking research of a fundamental character involving carefully designed experiments in varying the amount of advertising and measuring the sales results.[7]



Finally, more and more industrial marketers are recognizing the vital necessity of becoming truly customer oriented. Although the so-called marketing concept has attracted attention in the business press and has been adopted by many companies, its full implementation requires a favorable climate provided by top executives who provide the leadership, drive, and encouragement needed. As an outgrowth of a customer-oriented type of operation, it has been recognized that truly effective marketing strategy goes beyond the immediate customer and assures that the product performs in its ultimate use in the best possible manner. There are opportunities for communication with customers' customers to influence them favorably on behalf of the supplier's product. It is also being recognized that familiarity with the problems of marketing to ultimate consumers can be a strong sales aid when dealing with customers who are themselves manufacturing consumer goods.

THESE IMPACTS of the technological revolution pose complex but exhilarating challenges to industrial marketing managers. The profitable companies will be those who most successfully interpret and plan for the future in all important aspects of marketing operations.

## INDUSTRIAL MARKETING PLANNING

ARTHUR J. TACY

WHY, in a conference of some of the outstanding practitioners and students of industrial marketing, should the agenda include a discussion of marketing planning? Is there an implication that, in the performance of our marketing job, we are engaged in a quixotic flailing about without purpose or plan? I submit that this is not the case; but I hasten to point out that more failures in industrial marketing can probably be attributed to bad planning than to incompetence in carrying out the day-to-day subfunctions of marketing—including marketing research, product planning, advertising and sales promotion, marketing administration, sales, marketing personnel development, and product service. As a matter of fact, an objective appraisal might show that some companies' successes are the result not of divine vision on their part but of bad planning by their competitors.

In the following discussion, we will explore the vast opportunities in planning for more effective participation in industrial markets. And as we explore, we must remem-

[6] For an interesting discussion of distribution problems and opportunities see John F. Magee, "The Logistics of Distribution," *Harvard Business Review*, XXXVIII (July-Aug., 1960), 89-101.

[7] "New Need to Prove Ads Sell," *Printers' Ink*, CCLXXIV (Feb. 24, 1961), 24-27. This article reports that duPont is undertaking such a research program with industrial products.

ber that marketing planning will be little more than an interesting intellectual exercise unless it leads to risk taking and to the commitment of specific resources for achievement of specific beneficial results.

### PLANNING RESPONSIBILITY

In the preceding article, the author has defined succinctly the scope of industrial marketing as we see it and has described the dynamic changes taking place, largely as a consequence of unprecedented technological advancement. Sumner H. Slichter described research and development as "the industry of discovery, whose product is knowledge and whose growth is limited only by the supply of skilled personnel."

To the marketing managers of businesses selling to industry, these trends spell opportunities so abundant that one might ask why marketing planning is important or even necessary. The answer is that the accelerating changes in our industrial markets connote not only opportunity but a concurrent accelerating complexity of relationships with customers, distributors, suppliers, and the public. In the face of this growing complexity, industrial marketing cannot remain comprehensible, let alone manageable, unless we are able to simplify our marketing processes to balance the complexity of our markets and marketing relationships. This calls for planning.

The need for better marketing planning has become urgent as a consequence of the unprecedented high cost of bad guesses by management. There used to be many situations in which an alert industrial marketer could discern or conceive of an opportunity, move in fast with little risk, and, if the idea turned sour, get out equally fast with a nearly whole skin. Today, the time lag between innovation and achievement of substantial market penetration is commonly two or three years, and in the case of complex systems may be five to ten years. This means that large expenditures for research and development must be made long before profits accrue from sales. A wrong guess concerning the potentialities of the innovations could be suicidal, not only because of the financial loss but because the facilities and skills committed to the project are "frozen" (unavailable for other more promising ventures). Another reason for the high cost of bad guesses is the increasing ratio of capital investment to sales. Spurred by mounting labor costs and a buyer's market, manufacturers are investing heavily in equipment for automation of their plants and processes. Justification for these investments is based largely on the forecasts of sales. If plans for achievement of these forecasts are improperly conceived, the validity of the investment may be jeopardized.

The nature and scope of the marketing plan and the responsibility of the marketing manager for its development and implementation will, of course, depend on the characteristics and organization of the individual business. The American Marketing Association defines marketing planning as "the work of setting up objectives for marketing activity and of determining and scheduling the steps necessary to achieve such objectives." It is astonishing how many so-called marketing plans fail to meet this definition. They describe the goal or destination, but do not tell when we shall get there, the course we shall follow, where we shall be at each interval in time, the means of "transportation," the roadblocks to be avoided or eliminated, or the resources that must be provided to ensure completion of the journey on schedule.

The marketing manager is responsible, of course, for the establishment and implementation of the marketing plan. Perhaps more important, in most firms selling to industry today, he must take a leading part—if not the leading part—in the determination of the over-all business plan on which the marketing plan is based and with which it must be integrated. More and more, such firms are becoming market oriented. They are dedicating themselves purposefully to serving the

changing needs and wants of the market in a way that will provide customer values equaling or exceeding the price asked and that will not only enable the purchaser to do business with the firm but will make him want to.

### PHASE A— APPRAISAL OF ENVIRONMENT

Industrial marketers are not entirely free agents; they are cogs in the economic system. Their opportunities are determined largely by conditions existing and in prospect in our fast-changing world. Perhaps most marketing planners limit their consideration of the external business environment to a statistical analysis of the relationship between sales of their product or service and one or a combination of broad economic indicators, such as gross national product, industrial production, electric power output, or expenditures for producers' durable equipment. Such an analysis is helpful and desirable, but it is not enough. Of even greater significance for planning may be the changes in social, political, demographic, and international factors, and the technological changes brought about by the firm itself, its competitors, or the industries it serves. Many of these changes cannot be expressed statistically with any precision, and so they must be applied as judgment factors. All of them, including the economic climate, describe the external business environment that will determine the marketing opportunities available.

A few examples may illustrate the importance of these environmental factors. Political forces may be extremely significant to firms selling to government or government-regulated industries, such as electric utilities, railroads, and airlines. An increase in the minimum wage level could bring a demand for equipment to automate, in some degree, the retail trade and services industries. Social, demographic, and cultural changes can have great impact on the market opportunities available to firms manufacturing materials or components for consumer goods, including housing.

Ability to respond and adapt to its environment is a requirement for survival of any organism or organization; but some industrial enterprises have the ability to go beyond mere adaptation to their external business environment. They can influence or change that environment through technological advancements and marketing innovations that will improve their competitive climate.

### PHASE B— EVALUATION OF RESOURCES

The appraisal of the external business environment defines the marketing opportunities available and the obstacles or roadblocks impeding progress toward achievement of objectives. The next step in planning is a critical and objective evaluation of the resources available to the firm for making beneficial use of the opportunities presented.

Among the resources to be evaluated are:

**Financial strength** Will it support not only present operations but permit research, product and market development, growth, and integration for greater value added?

**Know-how in all business functions** Is it merely adequate or is it unique in significant areas? How much lead time do we have over competition and for how long can it be intained? How good are our patents or other proprietary assets?

**Facilities** Are manufacturing plants, laboratories, and sales and distribution facilities adequate and suitable for the opportunities envisioned, and are they efficient enough to enable us to become and stay competitive?

**Materials** Through integration or relationships with vendors, are we assured of an adequate and dependable supply of raw materials and components at favorable cost?

**Personnel** Do we have or can we obtain or develop the people needed to manage and staff the new ventures contemplated? Will

incompatibility with present operations complicate our employee relations?

**Marketing and distribution channels** Are they adequate and competent for rapid development of the markets contemplated? Will our reputation and company image in those markets facilitate or impede our success?

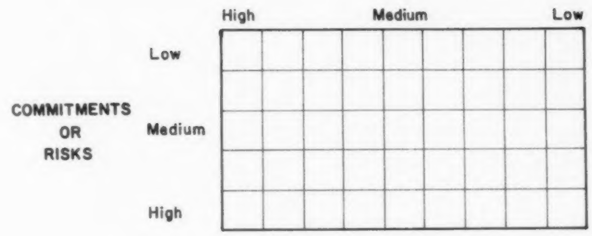
All of these questions must be examined from the viewpoint of the purchaser, not that of the company. There is always the danger that we will overestimate our product leadership and underestimate competition, that we will underestimate the time required for product and market development and will overestimate the rate at which we can increase our market share.

## PHASE C— OPPORTUNITIES AND ACTION

It is unusual in marketing planning to be confronted with a single "yes or no" decision—for example, to cultivate or not cultivate a market opportunity. Most businesses are diversified or are diversifying to such a degree that the current and prospective external and internal business environments disclose a variety of possible courses of action. Resources available are not ordinarily adequate for pursuing all of these alternatives concurrently, so it is necessary to rank on a consistent basis all of the market opportunities presented, the problems that will be encountered, and the resources that must be committed to enable the firm to achieve its marketing objectives. It is also necessary to develop criteria for evaluating the benefits and risks of each alternative.

Although a rational and objective approach is essential in this phase, it is unlikely that the analysis can or should be reduced to a rigid mathematical formula. Many of the factors involved cannot be measured or forecast with any degree of precision. Weighting or scaling devices and considered value judgments must be resorted to. One simple approach is to develop a matrix in this form:

**Opportunities or Benefits**




Opportunities or benefits (ranging from high to low) are scaled on one axis and commitments or risks (ranging from low to high) on the other. Each alternative course of action is then "spotted" at its appropriate position in the matrix. Alternatives in the upper left segment, representing relatively high benefits and low risks, are most deserving of further consideration. Since time itself is a factor, a three-dimensional matrix may be desirable with time as the third axis; alternatively, two two-dimensional matrixes can be constructed, one showing the short-range condition (a year or two hence) and the other the long-range picture, perhaps five years from now.

## PHASE D— ALLOCATION AND TACTICS

This is probably the most critical step in the planning process because it requires a choice from among the alternatives evaluated in the previous phase, of those business actions that represent the optimum balance of benefits to the firm versus resources which must be committed for their attainment. Its purpose is not a blue-sky portrayal of aspirations, but a down-to-earth plan of action, indicating where the business is going, by what means in terms of strategy and tactics, and at what cost in money, man power and other resources. It is at this point that marketing experience and enlightened judgment is most important. The decisions made must balance short- and long-range considerations.

As an illustration of the types of decisions required, consider the case of a material de-

veloped for sale to industry at a relatively high unit price, in limited quantities, and for specialized applications where its unique characteristics offer substantial customer value. Recent market developments and process improvements suggest a fundamental change in strategy. Technological advancement in other materials is increasing functional competition. Process improvements promise a substantial reduction in cost if large volume can be achieved, but a large investment in plant and equipment would be required. Market studies show a high degree of price elasticity. What to do?

Handled as a specialty, the material can be very profitable for several years. The existing marketing organization is adequate and competent to serve the limited specialty market. On the other hand, our marketing intelligence indicates that competitors have the means of matching our process improvements, but we have two to three years lead time. Eventual transition from a specialty to a mass market seems inevitable. If we make the change, should we price from cost, which will be relatively high in the early period of low volume, or should we do "advance pricing" to stimulate market development and establish a strong market position? If we change to a mass market approach, a substantial increase in the sales force will be needed. As a product acceptance is gained in individual markets and applications, use of distributors or agents would be appropriate to conserve our technical sales man power for development of new markets.



These and many other factors may have to be considered in arriving at a decision. Unless all significant factors are recognized and weighed, it is possible, if not likely, that the wrong decision will be made.

## PHASE E— INTEGRATING THE PLAN

It is obvious that marketing planning cannot be done in a vacuum. The relationship of marketing to each of the other functions of the business must be kept constantly in mind, and the marketing plan must be integrated or meshed with the plans of engineering, manufacturing, finance, and other departments and with the over-all business plan.

Without this integration, the management would be like a team of football players who met in a huddle and decided unanimously on a common objective—a gain of five yards on the next play. This is fine; here is a clear objective and a do-or-die determination to achieve it. The only trouble was that each man had a different idea of the play to be used. The quarterback faded back to pass but found that the end, who expected a wide run, was blocking the secondary. The guard, expecting a trap play, let the defense in, and the quarterback was tackled for a 10-yard loss. This can happen in business as well as in football. If marketing is planning on a new or improved products to be marketed at a certain time, engineering and manufacturing must have plans to deliver them. If marketing plans to increase sales and market position by use of attractive terms or financing arrangements, the finance department must make certain that the funds needed are available.

Any plan, including the marketing plan and other plans for the business, is based inevitably on certain assumptions. Those assumptions should be stated specifically and clearly in the plan. If in time they prove to be invalid, the plan should be reviewed and, if necessary, changed. Paraphrasing Robert Burns, we can say that "The best laid plans of industrial marketers often go awry." Most of us know to our sorrow how true that is. Accordingly, it is an excellent idea to include in the marketing plan a description of "escape routes," which can and will be taken if certain unforeseen events make it impossible or unwise to follow the course of marketing action laid down. This does not mean that you are planning for defeat. You are still planning to win, but to reach your objectives by different means, which are required by unforeseen circumstances. Among such circumstances may be unusual

competitive retaliation to your marketing moves, a key strike, a fire or other casualty, a technological breakthrough, or a sudden change in the international environment. You cannot, of course, have a detailed plan to cover every eventuality, but you should have at least one or two escape routes or alternative courses laid out for use in case of extreme emergency.

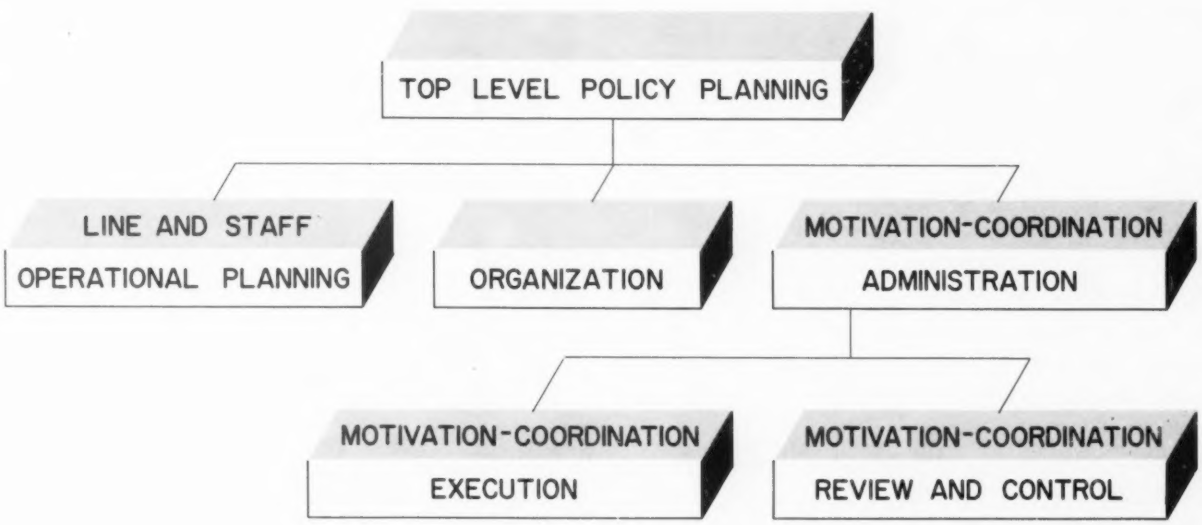
MARKETING planning is a major element in the marketing manager's responsibility to his firm, but he must also dedicate himself to the implementation of the plan and accept accountability for achieving its objectives. Only then can marketing planning make its contribution to that all-important number at the southeast corner of the profit-and-loss statement—net income.

## MANAGING INDUSTRIAL SALESMEN

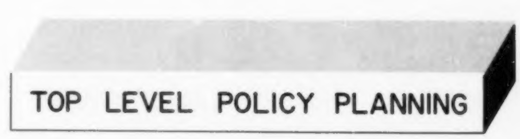
FRANK W. HANKINS

FIGURE 1

**Sales Management**




THIS APPROACH to industrial sales management has been developed out of twenty-five years of working with industrial firms in helping them get more effective work from their sales forces. There are four major steps in this approach (see Figure 1): top-level policy planning, operational planning, organization, and administration (execution, and review and control). All these steps are continuously interrelated in the whole process of industrial sales management.




Definition: Establishing a framework of policy within which the sales objectives of the company may be achieved

This step refers to a framework of policy within which the company's sales objectives may be achieved. I am not going to dwell on this phase; while it is extremely important for every company, the kinds of policies that

each company develops will depend upon its own particular situation. I am more concerned that, whatever the policies may be, they are arrived at by consultation using the ideas of everyone concerned, and that the policies are based on complete factual information about the customers and prospects, and competitors as they are related to the particular company. It stands to reason that the policies developed ought to be stated precisely and that everyone concerned ought to know what the policy position is.

## LINE AND STAFF
## OPERATIONAL PLANNING

Definition: Establishing procedures and objectives in advance against which the quality and quantity of work may be controlled

Within the top policy framework, operational planning establishes procedures and objectives in advance, against which the quality and quantity of work may be controlled. We are required to analyze the task to be accomplished, to set realistic standards of performance, and then to work out procedures to accomplish the results wanted.

Analyzing the job begins with a thorough understanding of our market through the process of market clarification; we must locate it, measure it, and define it, not in a general way, but account by account. In other words, we need a complete census of customers and prospects. When we finish, we ought to know the amount and kinds of products both we and our competitors are selling to every account in the market or territory and should be able to answer the next question, "How many salesmen at what sales expense do we need to reach the goals we have set?" It would be useful to create a yardstick such as one of my clients uses, which shows that the $270-to-$300-a-year customer is worth about three calls a year, while a prospect needs to have a potential about six times that big to justify an equal number of calls. In the same way, a customer with a $12,500 account would warrant 48 calls per year or nearly one per week. To justify 48 calls, a prospect would need to have a potential of $75,000. With this kind of yardstick, we can work out the best combination of calls on prospects and customers to get the most effective 960-call load for a salesman for a year.

Next, we can work out routes and specific procedures that will conserve travel time and increase the actual face-to-face time with customers and prospects. When we have operations planned through cooperation between the line-and-staff groups, we can begin to work on the details of the organization that will be needed to get the job done.

## ORGANIZATION

Definition: Setting up the structure of responsibilities and normal interrelations

Organization involves setting up the structure of responsibilities and normal interrelations that will implement the procedures to reach the objectives of quantity and quality of work necessary. We must solve five kinds of related problems: charting the organizations; assigning responsibility; delegating authority; tracing accountability; and clarifying the character of collaboration.

Solutions to these problems are made possible by job clarification. Here I suggest the use of what I have called the IRAC, which requires answers to questions to be answered (in each case, we need to know the conditions involved) about each job in the organization structure:

**I** Initiation. Who starts it?
**R** Responsibility. Who does it?
**A** Approval. Who approves it?
**C** Collaboration. Who helps?

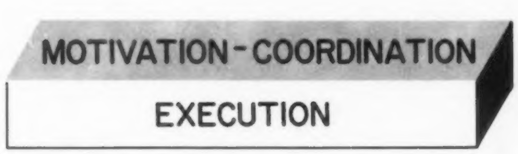
Now we have our operations planned and an organization set up, which we hope will help us get to the sales objectives we want to accomplish within the policy framework

established at the top level. These plans, procedures, and organization structures will not work automatically; they require direction, motivation, and control. This is administration.


Definition of administration: Meeting planned procedures and objectives through guidance and evaluation of activity

Administration, as I shall use the word, means seeing to it that the planned procedures and objectives are met through guidance and evaluation of activity. This involves two phases or parts, execution, and review and control. Administration is not a push-button process; it requires leadership, motivation, and coordination. At this point, I want to stress managerial involvement. Take the sales manager who says, "Here is the price book or catalogue. There are the four counties and territories in the Southeast. Good-by and God bless you." The one who simply gives orders on how to handle the business is involved only slightly.

The sales manager who draws out the conditions at the points of sale, possible buyer's reactions, the needs that might be uncovered, and the skills the salesman might need to uncover them really becomes involved in every salesman's job and can provide the guidance and motivation that will help each salesman get the most out of his territory.




Definition: Directing and carrying forward planned procedures as delegated

For the sales manager, the "doing" consists of directing and carrying forward planned procedures as they have been delegated to him. This means instructing, guiding, and stimulating his sales force. How can we stimulate or encourage salesmen to work harder and to work "smarter"?

Compensation is supposed to stimulate people to work harder; but I think it is somewhat overrated. Perhaps a fixed and variable plan of payment could be set up, so that the "fixed" would cover the necessities and provide about two-thirds of the total the salesman is expected to earn. This provides reasonable control of the activities of the salesmen. The variable part should reflect either the selling difficulty or the gross profit, so that sales pressure can be increased on harder-to-sell items. This variable part of the compensation ought to be paid as often as possible (a quarterly payment seems to be the average compromise).

The next step is to train our salesmen to work "smarter" through a coaching program that will begin with an exploration of coaching needs through appraisal of the salesman's performance, a study of relations between customers and salesmen, and observation of the salesman in action. There are a great many ways of getting the coaching done. A few of them are the "executive nudge," out-of-office discussions, joint calls, courses, books, a specialized coaching staff, the product staff, and outside sales management counsel. I have two clients who use industrial psychologists effectively for this purpose. The whole business of instruction and guidance, plus practice selling, ought to be evaluated to see whether or not the teacher has really taught. Instruction and guidance can also extend to the use of sales tools that lend leverage to mere words.

Many of my clients seem to throw sales training out the window, but expect a man to come to work and get immediate results. Their theory seems to be "train him, bat him around, box his ears to a peak and then knock the peak off"; by and by you'll get a salesman—but at what a cost in lost time, lost sales, and lost customers!

## MOTIVATION-COORDINATION

## REVIEW AND CONTROL

**Definition:** The determination of whether or not objectives have been achieved

Here we determine whether objectives have been reached, and whether procedures planned with the involvement of the sales manager have been carried out. This involves a comparison of results with objectives to form the basis for future planning or new strategy. Setting the stage for future planning by establishing a regular review on a quarterly basis takes the comparison out of a climate of criticism and continues the involvement of both the salesman and the sales manager. Such a comparison always raises the question, "Did we ask enough questions of enough people to form a sound basis for future planning?" We may go over the guide list in the quarterly review and find that our strategy didn't work, and we know no more about the account than we did before, about who thinks what and who influences purchases. If people are not telling us at least twice a week that it's none of our business, we aren't asking enough questions. However, this is the way to find out why customers buy competitive items, and, at this point, we get back to operational replanning.

### OPERATIONAL REPLANNING

This means reanalyzing our tasks, resetting our standards and re-establishing our procedures by taking a new start. We do this by reviewing our past performance, checking and re-examining our opportunity, and planning future action. I suggested a while ago that we should avoid a critical climate. For every customer, we should re-examine the potential, three years' past sales by product groups, the calls made, and the calls planned.

This forms the foundation for planning the next quarter's strategy by considering the courses that are open for increasing our share of the particular customer's business. What objections must be met? What features should be emphasized? What sales tools should be used? What special business interests does the customer have? Can the salesman use support?

In the quarterly review, decisions involving both the sales manager and the salesman can result in changing the call procedure, raising or lowering the planned calls on the basis of revised forecasts for specific reasons with some allowance for the sales manager's judgment. The quarterly review helps the salesman reappraise himself and strengthen his performance by reviewing in an uncritical atmosphere his basic knowledge of his job, his performance at the point of sale in selling himself, selling the product, and his skill in handling objections.

Each quarter, he is encouraged and given help in managing his job by reviewing his work and by preplanning, and stimulated to improve and develop himself as a better and more productive salesman. Regular examination will reveal some things about himself, about his ability to hold established business, to expand coverage on old accounts, to penetrate new accounts, and to introduce and sell new products. The net result is a more productive sales force with the sales manager involved all the way.

TOP-LEVEL management sets up a framework of policies, arrived at by the use of facts and with the benefit of the ideas of several people. Within this framework of policy, operational planning and organizing take place with continuous involvement of the sales manager to get the planned sales effort and expense. In the administration of the sales work of the company, the sales manager still heavily involved uses instruction, guidance, and stimulation to get his salesmen to work harder and to work "smarter."

A regular pre-established process of review of past performance, with respect to both goals and procedures, serves as the basis for detailed replanning of operations for the next period.

Copies of this issue are available from the School of Business, Indiana University, Bloomington, Indiana, at $2.00 each. Complimentary copies have been sent to each subscriber.